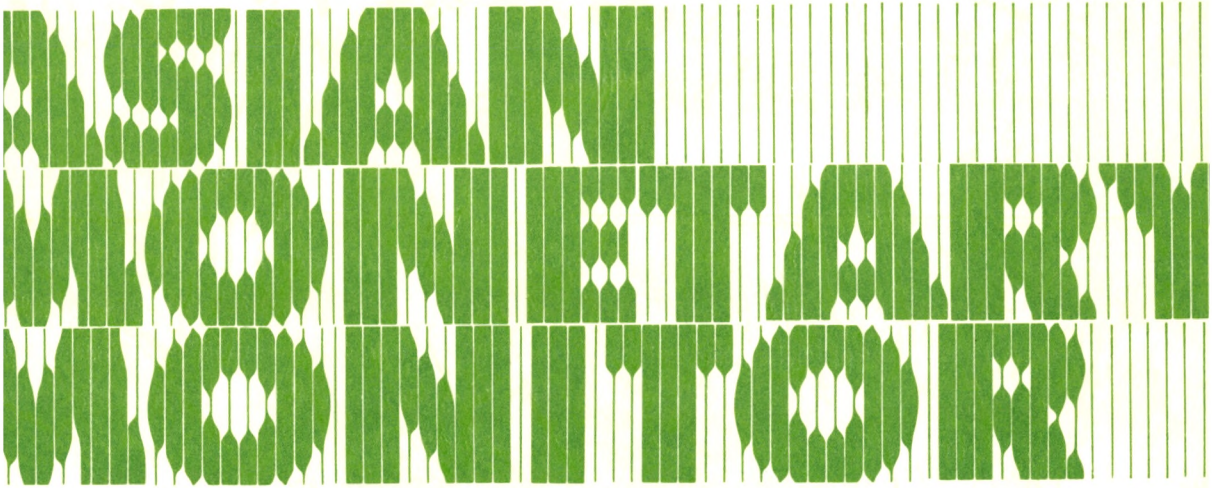




CONTENTS

	Page
REGIONAL SURVEY	
Misplaced Concern Over Lower North East Asian Export Growth by Joanne Gudgin	1
INDIA	
Economy To Blossom, But Fiscal Pruning Is Postponed by Philip Wyatt	9
INDONESIA	
Policy Choices For The Economic Upswing by Simon Ogus	18
ECONOMIC CAPSULE	
Malaysia: Bank Negara Declares War On "Currency Speculators" SLO	28





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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price US\$300 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to the Editor, Asian Monetary Monitor Ltd., GPO Box 12964, Hong Kong.

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ASIAN MONETARY MONITOR

January-February 1994

Vol. 18 No.1

MISPLACED CONCERN OVER LOWER NORTH EAST ASIAN EXPORT GROWTH

As North Asia (defined here as Japan, Taiwan, South Korea, Hong Kong and Singapore) have progressed up the ladder of economic development, their comparative advantage has moved towards tertiary and high technology industries. Thus, many secondary industry firms have shifted production offshore to South Asia (defined here as Thailand, Malaysia and Indonesia) and China, which have started to exploit their comparative advantage in these sectors. As this structural adjustment has taken place North Asia has experienced falling export growth whilst in South Asia export growth has accelerated significantly (Chart 1). The decline in the export growth of North Asia can be attributed to a number of factors including weak external demand, changes in the North Asian export product mix, and, perhaps, the relocation of export capability to South Asia. This article is concerned with the third of these factors and raises the question "to what extent can export growth in South Asia be attributed to the relocation of North Asian export capability to these markets?".

The relocation of production from North to South Asia has been driven by a combination of push factors -- factors making North Asia less attractive -- and pull factors -- factors which make South Asia more attractive. Following the Plaza Accord, in September 1985, the currencies of North Asia (with the exception of the pegged HK\$) began to appreciate against the US\$ -- between 1985 and 1990 the Yen appreciated 43%, the NT\$ 33%, the Korean Won 17% and the S\$ 16% -- leading to a fall in export price competitiveness (Chart 2). Rising wages and property prices in North Asia have further eroded their competitive positions. Since 1986, wage costs in US\$ have been increasing by an average of 25% per annum in Korea, 18% in Taiwan, 13% in Singapore and 11% in Hong Kong (Chart 3). Prime office capital rentals have also been increasing by a dramatic 29% per annum in Taipei since 1986 and by 18% in both Hong Kong and Singapore (Chart 4). (No

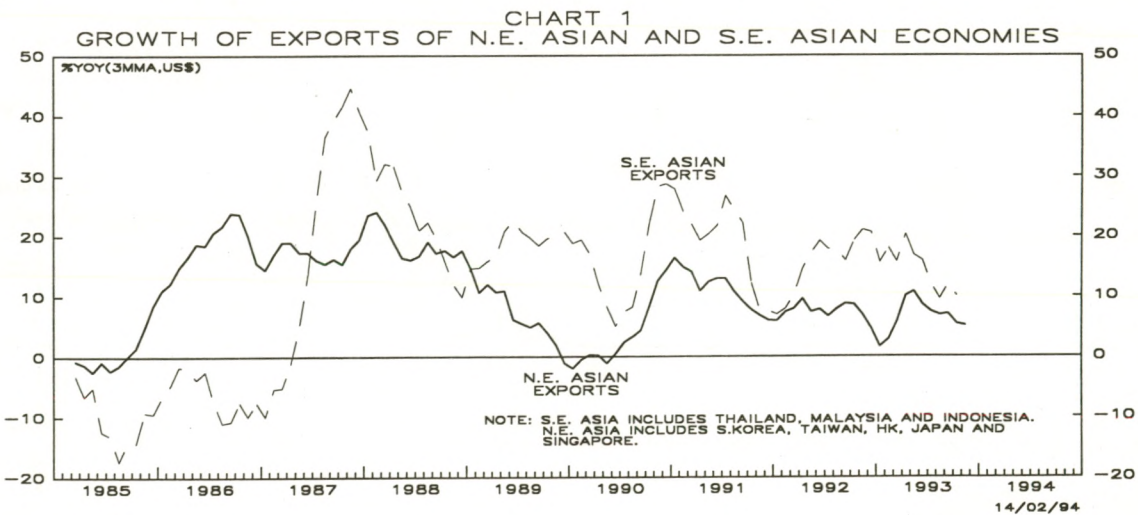


CHART 2
NE ASIAN CURRENCIES VERSUS THE US\$

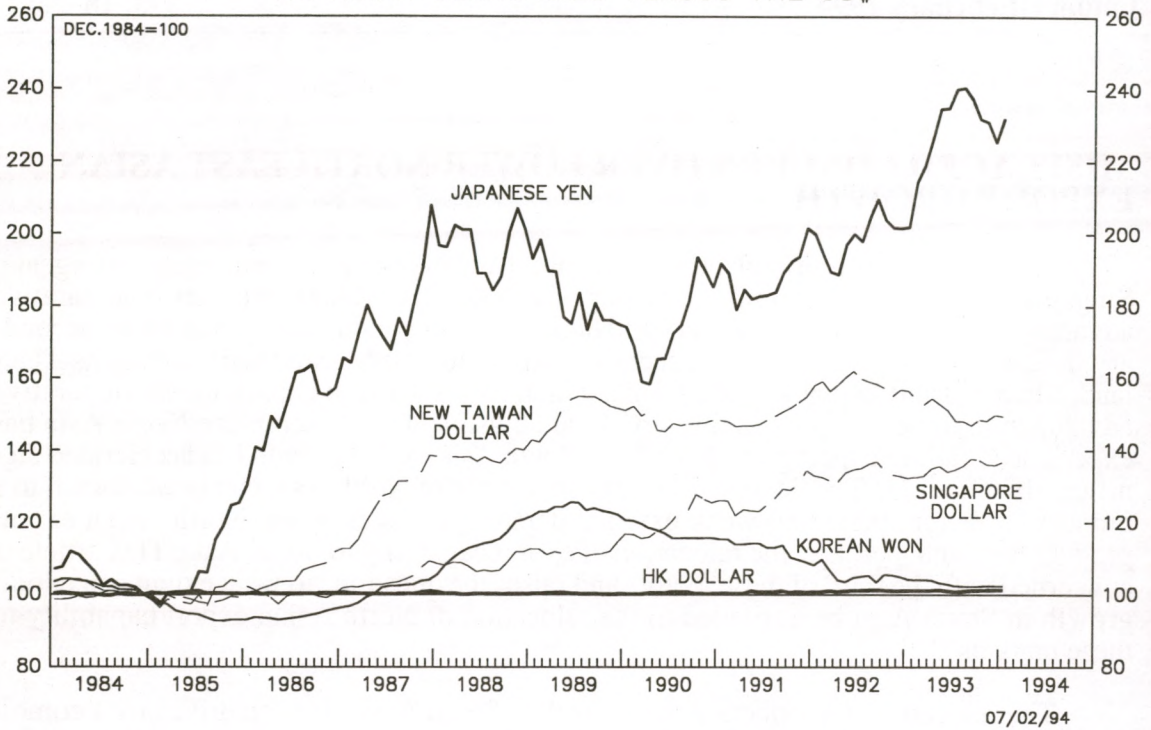


CHART 3
WAGE COSTS IN US\$ IN THE ASIAN NICs

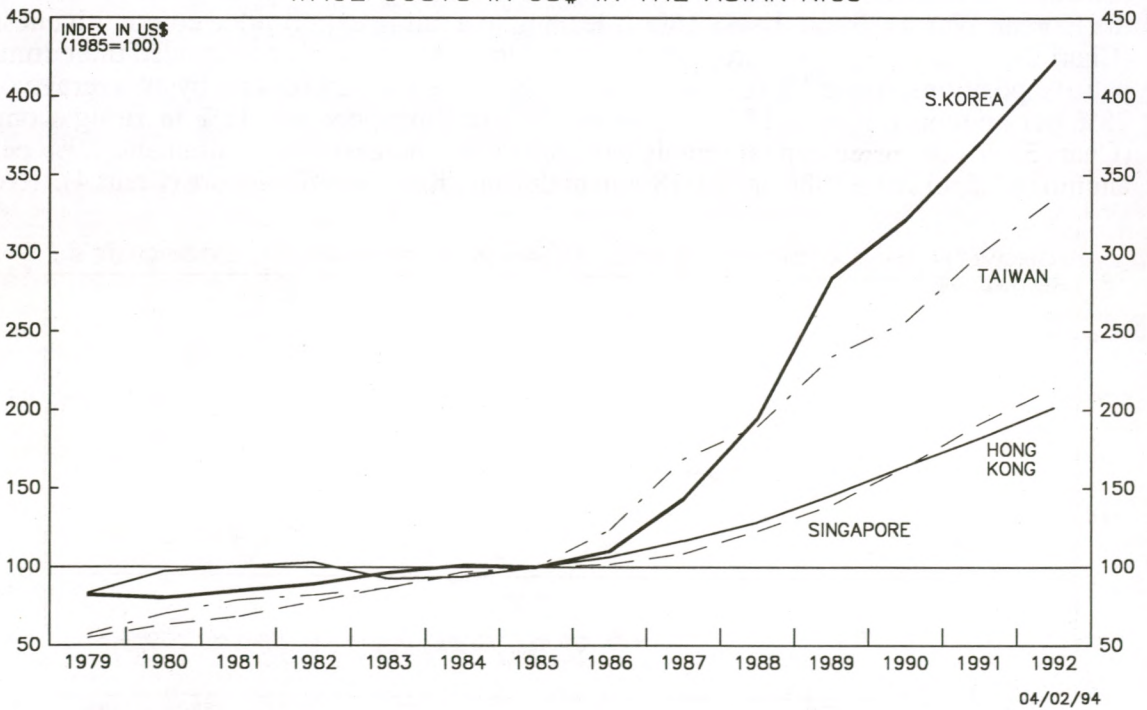
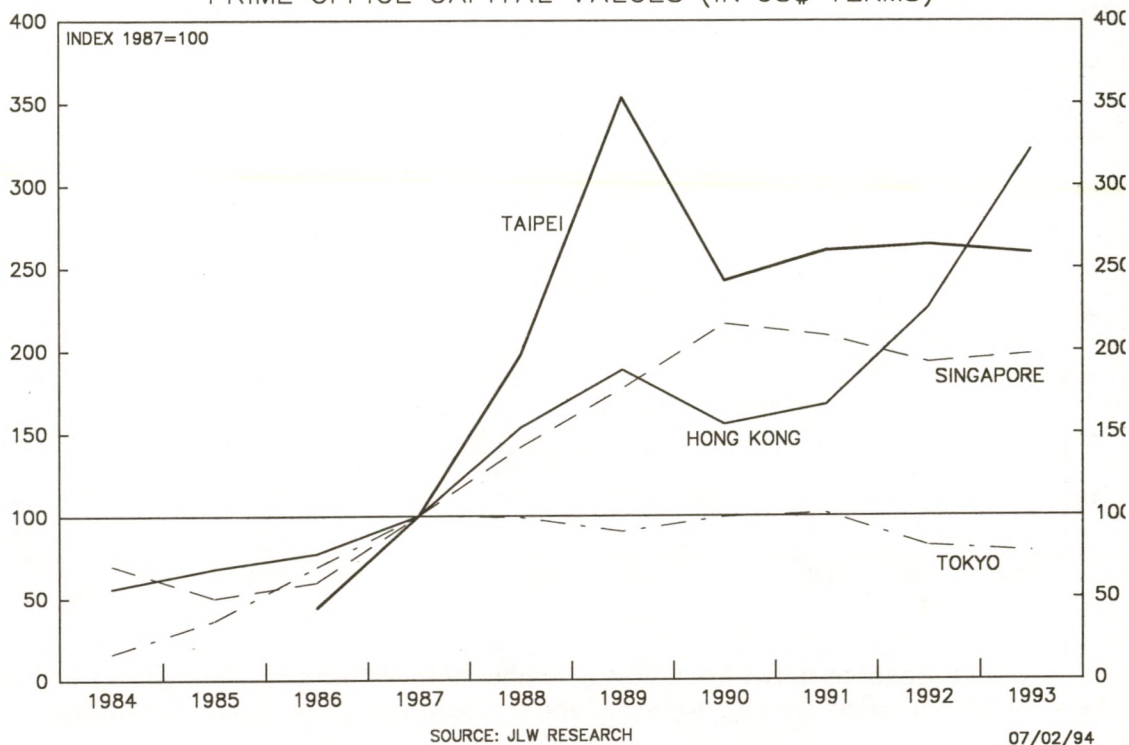


CHART 4
PRIME OFFICE CAPITAL VALUES (IN US\$ TERMS)

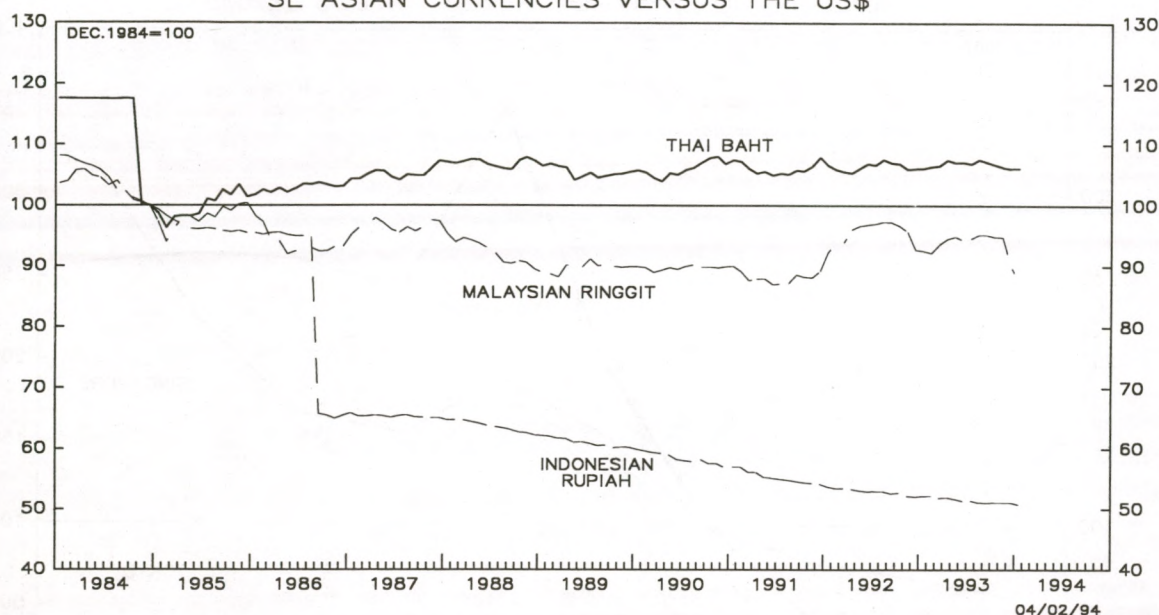


hard data is available for South Korea but Seoul has experienced similar trends over this period.)

The South Asian economies have been benefitting from the deteriorating competitiveness of North Asia but their export competitiveness has been further improved as their currencies have (except for the stable Baht) depreciated against the US\$ (Chart 5). The attractiveness of the South Asian economies as locations to invest has been further enhanced by the provision of relatively cheap labour in abundant quantities, close proximity to regional markets, and buoyant domestic markets. Added to this the governments of these economies encourage FDI through incentives such as tax holidays, low cost credit and specialised infrastructure such as industrial estates. It is the combination of these factors, and the ease with which technology transfer is now facilitated, that have created the new intra-Asian trade and investment flows.

The analysis of intra-Asian investment flows requires the use of data on Foreign Direct Investment (FDI). However, comparability of FDI statistics across economies is difficult and the data must be treated with caution. Variations exist in the definition of FDI, the threshold ownership level and coverage in terms of sector, source and time scale. Comparison between two economies can therefore be misleading. For example, data on the USA includes only realised FDI whereas data on Japan counts all approved FDI. As only 40% of approved Japanese FDI projects in developing countries are implemented, Japanese FDI is overstated. Comparison is also constrained by coverage. For example, Malaysia only releases figures on the manufacturing sector and Thailand has only published FDI statistics since 1987. Thus caution is necessary. Data on the sectoral distribution of FDI in China is limited, making an analysis of FDI-related trade flows extremely difficult.

CHART 5
SE ASIAN CURRENCIES VERSUS THE US\$



Data limitations notwithstanding, a number of investment and trade flow trends can be gleaned that reflect the ongoing structural readjustment of the Asian economies.

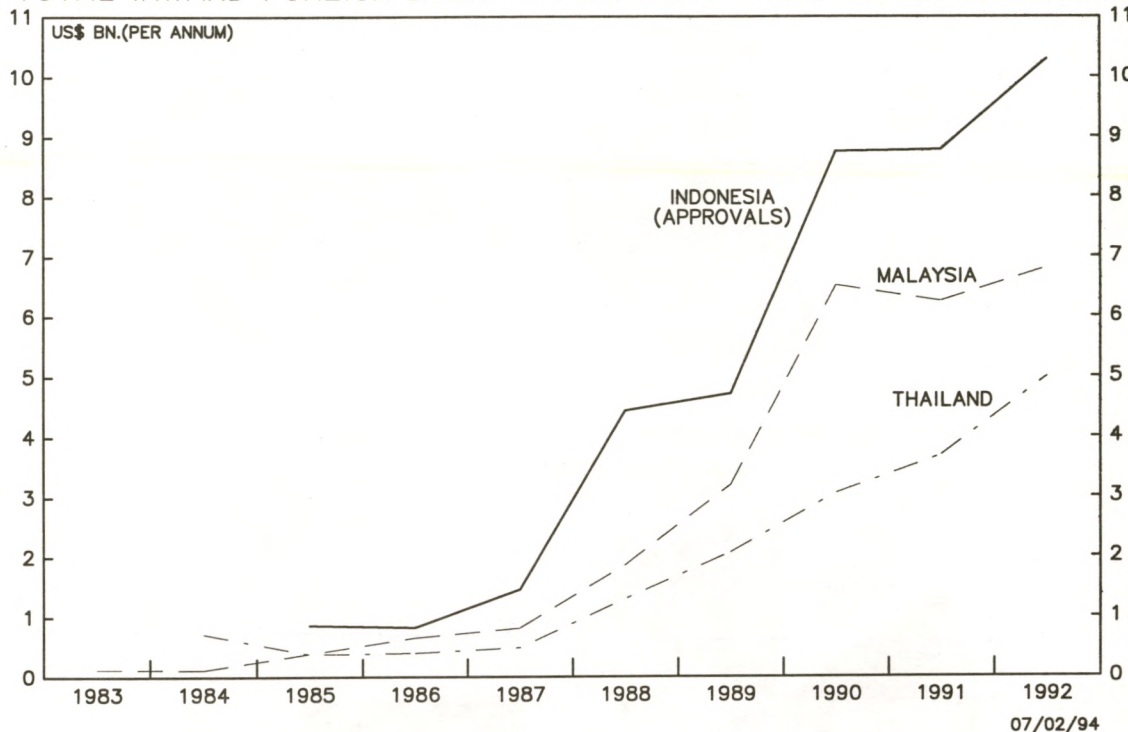
The growth of FDI to South Asia accelerated over the 1980s, peaked in 1990-91 and since then has been expanding at a slower rate (Chart 6). This is primarily because FDI from Japan has been declining as that country has entered recession. However, FDI from the NICs (Singapore, Hong Kong, Taiwan and Korea) has been increasing and is now the major source of FDI in Thailand and Indonesia (Table 1). Since January 1993 the Yen has begun another episode of sharp appreciation -- appreciating 13% against the US\$ between January 1993 and January 1994 -- and it is possible that this will induce another wave of Japanese investment similar to that experienced in 1985-89. Not only has the source of FDI changed, but so has the sectoral distribution. There has been a significant rise of FDI into tertiary sectors such as construction and services. In Thailand, 39% of total FDI in 1988 went to the tertiary sector, by 1992 the proportion was 60%. In Indonesia, the tertiary sector received 23% of total FDI in 1992, up from 12% in 1988. Data on the tertiary sector is not available for Malaysia but the trend in South Asia is evident.

Table 1: FDI - % SHARE BY SOURCE

Source Destination	US	1986 Japan	NICs	US	1992 Japan	NICs
Thailand ¹	20	36	23	22	26	44
Malaysia	3	7	15	7	15	12
Indonesia	19	40	17	9	15	26

¹ 1986 refers to 1987 in Thailand

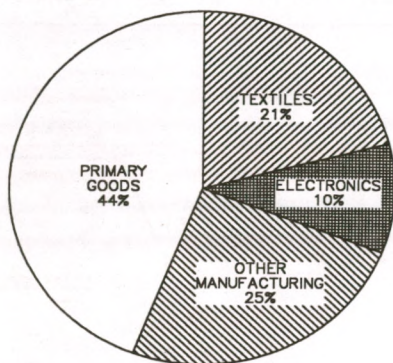
CHART 6
TOTAL INWARD FOREIGN DIRECT INVESTMENT IN S.E. ASIAN COUNTRIES



The export structure of the South Asian economies has also been changing dramatically over the past decade. In all cases, manufacturing goods now account for the majority of exports. (A cautionary note must be sounded as an export will often be categorised as manufactured even if its production involves only a minimal amount of processing and transformation to a primary commodity. Nevertheless, the trends are still clear.) Chart 7 illustrates the change in the export composition of these economies. The growth of manufacturing exports has been driven particularly by expansions in the textile sector in Indonesia and the electrical product and machinery (electronics) sector in Thailand and Malaysia.

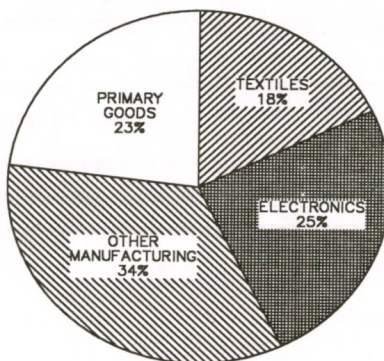
The electronics sector accounts for 40% of total exports in Malaysia and 25% in Thailand. The growth of this sector in both economies is clearly related to the relocation of export capability. In Thailand the export of electrical products was so small in 1986 that it was incorporated in to the "other" category of exports. However, by 1988 17% of total exports were from the electronics sector and this grew to 25% by 1992. This sudden growth was preceded by large amounts of FDI in the electronics sector -- 28% of total FDI in 1988. FDI into this sector has started to decline but exports continue to grow as domestic competitors emerge spurred by technology spillover. A similar, but not as striking, pattern can be seen in the Malaysian economy. In 1986, 6% of total FDI went to the electronics sector and by 1988 export of these goods had increased to 27% of total exports up from 24% in 1986. By 1988 21% of total FDI went to the electronics industry, inducing an expansion and increasing electrical exports to 40% of total exports by 1992. In both Thailand and Malaysia, the relocation of export capability to the electronics industry through FDI seems to have induced rapid export expansion.

CHART 7
THAILAND: EXPORT STRUCTURE



1986

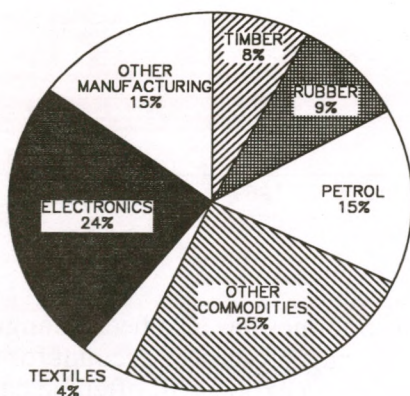
TOTAL EXPORTS: BAHT 233383 MN.



1992

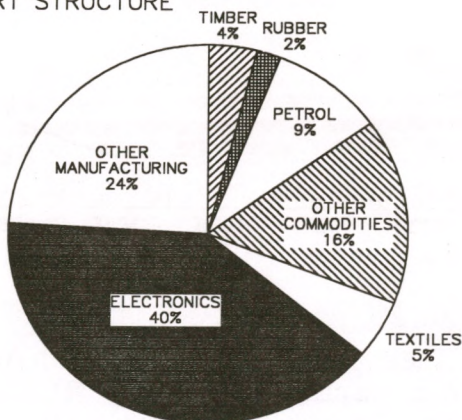
TOTAL EXPORTS: BAHT 824644 MN.

MALAYSIA: EXPORT STRUCTURE



1986

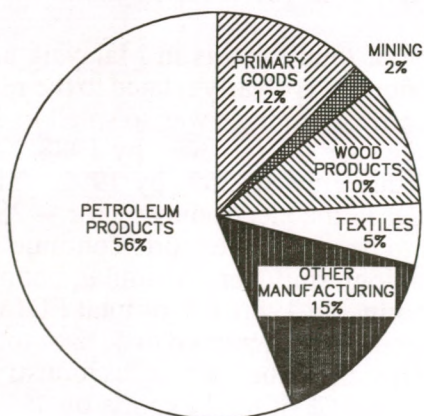
TOTAL EXPORTS: M\$ 35319 MN.



1992

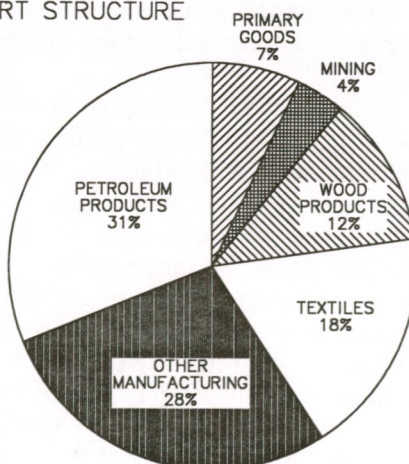
TOTAL EXPORTS: M\$ 103657 MN.

INDONESIA: EXPORT STRUCTURE



1986

TOTAL EXPORTS: US\$ 14805 MN.



1992

TOTAL EXPORTS: US\$ 33967 MN.

Indonesia is poorer and less developed than Thailand and Malaysia and consequently has a different industrial structure. The electronics sector is not a major export industry in Indonesia but the relocation of export capability is evident in the textile industry. In 1988 textiles accounted for 7% of total exports but by 1992 they accounted for 18%. This sudden expansion in the textile industry followed a sharp rise of FDI into the sector -- from 1% of total FDI in 1986 to 13% by 1990. By contrast, the textile sectors in Thailand and Malaysia have experienced constant, low levels of FDI and a constant proportion of exports.

Data on the repatriation of profits from South Asia to North Asia would be useful in determining the relative importance of these trade and investment flows. Unfortunately this data is difficult to obtain on a consolidated basis but the information can be gauged using data on sales and exports of North Asian firms operating in South Asia. In Thailand 30% of all exports in 1990 were produced by foreign affiliated firms, of which 7% were by Japanese affiliated firms. The figures are more striking in the electronics sector where 84% of exports in 1990 were produced by foreign affiliated firms, of which 50% were by Japanese firms. The relocation of export capability to Thailand accounts for a significant proportion of exports and is particularly important in the electronics sector. Data on Malaysian exports is limited to Japanese affiliated firms and data for Indonesia is only available for Japanese affiliated firms in the electronics sector. In 1989 Japanese affiliated firms accounted for 10% of total Malaysian exports -- a figure similar to that of Thailand. 18% of electronics exports were produced by Japanese affiliated firms, suggesting that FDI is less concentrated than in Thailand. Oil and petroleum products as well as electronics are an important component of the Malaysian economy. In Indonesia, Japanese affiliated firms accounted for 18% of total 1990 electronics exports. This indicates that a significant proportion of Indonesian exports are due to relocated export capability.

The pattern of export capability relocation illustrated above is supported by changes in the export structure of the North Asian economies. Over the last decade all of the North Asian economies have experienced decreases in their exports of textiles. For example, Taiwanese textile exports have fallen from 24% of total exports in 1980 to 5% in 1992. In the case of Hong Kong and Singapore this refers to domestic textile exports which have declined and now account for a minority of total textile exports. For example, in 1986, Singapore's domestic textiles accounted for 73% of total textile exports however by 1992 this had fallen to 36%. Re-exports from Guangdong in the case of Hong Kong and Johor in the case of Singapore are increasing as these provinces exploit their comparative advantages in textiles. In line with the decline in the domestic production and exports, all of the North Asian economies have increased their imports of textiles.

All of the North Asian economies except Taiwan have also seen a decline in the export of electrical goods and machinery. For example, in Hong Kong these goods accounted for 62% of total 1986 exports. However, this fell to 26% in 1992. Simultaneously, these economies have started to import more electrical goods and machinery in order to service the domestic market. In Hong Kong, for example, imports of these goods as a proportion of total imports has increased from 24% in 1986 to 32% in 1992. Taiwan has also experienced an increase in the import of electrical goods and machinery but has seen a rise in the export of these goods. For example, in Taiwan 44% of total 1992 exports were comprised of goods from the electronics sector, up from 32% in 1988. This is mainly due to an increase in the export of heavy machinery which accounted for 10% of total exports in 1986 and 19% in 1992.

SUMMARY: Concern over the state of the North Asian economies based on declining export growth is less worrisome than it first appears. Clearly the recently emerged intra-Asian FDI flows have aided the ongoing restructuring of the South Asian economies. The relocation of the North Asian production base to South Asia has allowed North Asian firms to capture a significant proportion of the export market share. Thus whilst exports from North Asia are growing less rapidly, exports produced by North Asian firms may not be slowing¹. Unfortunately this is difficult to quantify as data on profit repatriation is not readily available². However the figures on export market share clearly show that North Asian firms are still significant exporters. The exports by North Asian firms from South Asia benefit the North Asian economies through the repatriation of profit.

¹ The problem of measuring trade flows in a world of multinational firms has taxed the US authorities for many years so it is unsurprising that measurement difficulties are encountered in Asia. Two recent studies by the Department of Commerce (DOC) and the National Academy of Sciences (NAS) seek to measure trade on the basis of ownership rather than location. The DOC has added net sales by foreign subsidiaries to US exports (and vice versa for imports) and turned a US\$28 billion goods and services deficit in 1991 into a US\$24.3 billion surplus. The NAS method goes further and defines exports as the sum of: cross-border sales to foreigners; net sales to foreigners by subsidiaries abroad; and sales by American firms to American subsidiaries of foreign firms. This boosts the surplus further to US\$164.1 billion. It may be fair to assume that North Asian trade statistics would similarly benefit from such recalculations.

US Trade in Goods and Services 1991, US\$ billion

	<u>Unadjusted</u>	<u>DOC Measure</u>	<u>NAS Measure</u>
Exports	581.1	632.0	498.2
Imports	<u>609.1</u>	<u>607.7</u>	<u>334.1</u>
Balance	-28.0	24.3	164.1

² IMF figures on foreign direct investment treat retained profits of foreign-owned businesses as though they had been repatriated. However, reconciling IMF data with other sources is a Herculean task for the reasons explained above.

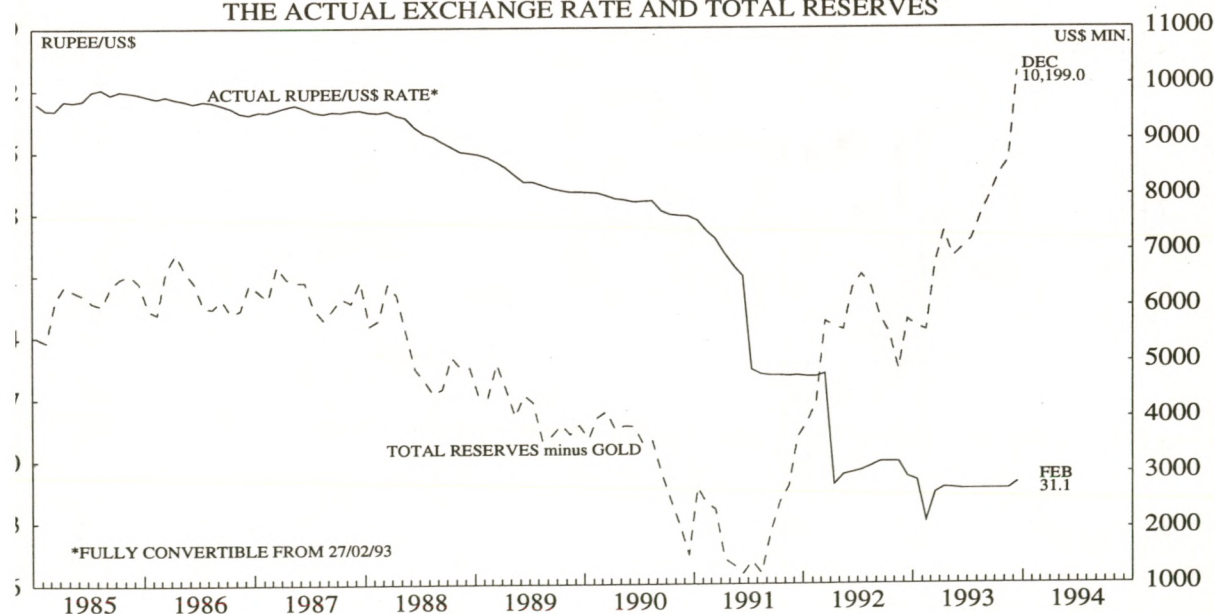
INDIA ECONOMY TO BLOSSOM, BUT FISCAL PRUNING IS POSTPONED

Introduction

Over the last three years the Indian economy has undergone a series of progressive reforms (see AMM Vol 17 No.1) which are gradually changing the nature of the economy. By introducing a greater degree of competition India is attempting to move away from the inward looking import substitution policies favoured in the past to more export orientated ones. However this is a slow process since it involves dismantling much of the overstaffed public sector machinery. Since Narasimha Rao took office in July 1991, taxes, tariffs and some other less visible import restrictions have been removed. In addition the Rupee has been made convertible on the trade account and, at the time of the latest budget slightly more convertible on the current account. Foreign capital is now more welcome than it has been in the past. A loosening of the restrictions on foreign direct and portfolio investment, coupled with the relatively low cost of capital in the US dollar bloc over the last couple of years has led to a substantial rise in capital inflows.

Since the Rupee was made convertible on the trade account a year ago the Reserve Bank (RBI) has adopted a policy of holding the Rupee/US\$ rate at 31.4 (Chart 1). This has meant that the improvement in the balance of payments over this time has led to a rapid accumulation in foreign exchange reserves which is now generating faster monetary growth. In this article the recently announced budget deficit for 1994-95 is discussed along with the outlook for monetary policy. As the overall monetary stance is likely to remain stimulative over 1994, the stage is set for stronger economic growth and healthy gains in equity and other asset prices in the year ahead.

INDIA: CHART 1
THE ACTUAL EXCHANGE RATE AND TOTAL RESERVES



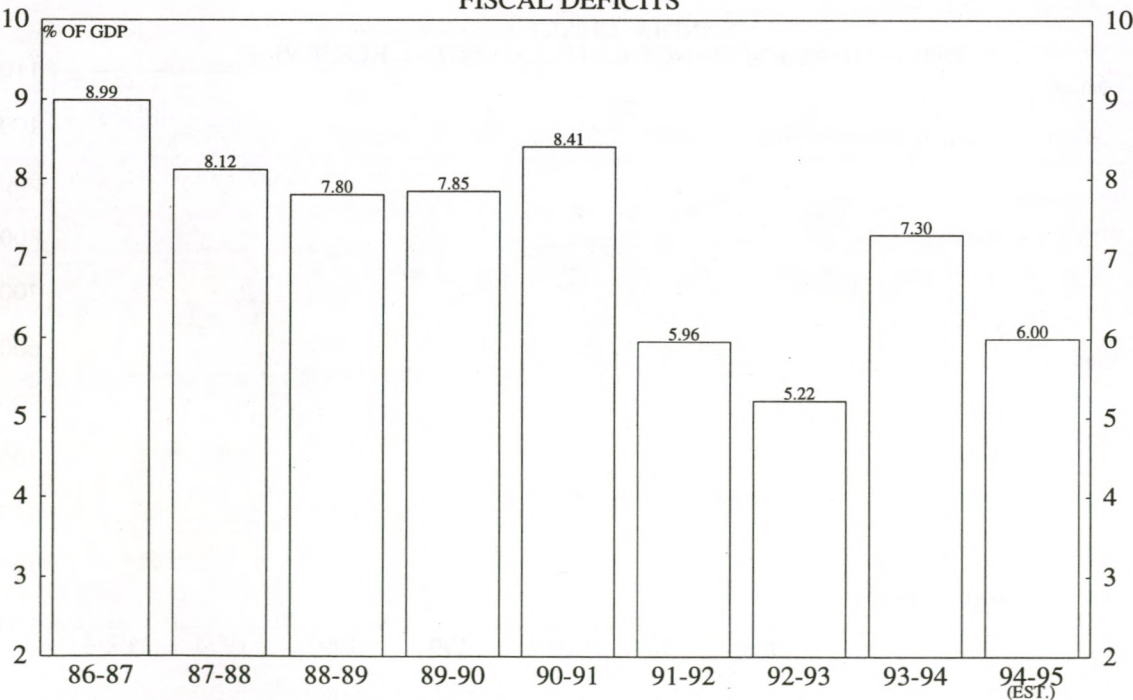
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The Fiscal Position

The revised figures for the 1993-94 budget showed the deficit overshooting official expectations by a significant margin (Chart 2). Instead of 4.6% of GNP the revised budget deficit figure for the 1993-1994 fiscal year is 7.3% of GNP. To a large extent this reflects the slow economic growth in India over the last 12-18 months (Chart 3). Capital expenditure (23% of total budgeted spending) overshoot expectations by 14% while operating expenditure which accounts for the remaining 77% of budgeted spending exceeded expectations by 8.3%. On the revenue side, tax receipts were underestimated to the tune of 10%. In the 1994-95 fiscal year the government expects to cut its capital expenditure by 2% with operating expenditure up 8%. The Finance Minister is counting on a rebound in industrial output coupled with better tax administration and compliance to buoy tax revenues over the forthcoming year such that tax receipts rise by 13%. This would produce a fiscal budget deficit of 6% of GNP in 1994-95 on his calculations.

As far as taxes are concerned the Finance Minister has made some tax and tariff cuts in the 1994-95 budget in line with his quest to free up the Indian economy. While these bode well for India's longer term economic growth, they may contribute to disappointingly low tax revenues this year especially given the continued lack of automatic and transparent tax collection incentives in place. However there has been little change in the multitude of procedures that the taxpayer is required to complete. The main changes in taxes made in the 1994-95 budget are:

INDIA: CHART 2
FISCAL DEFICITS



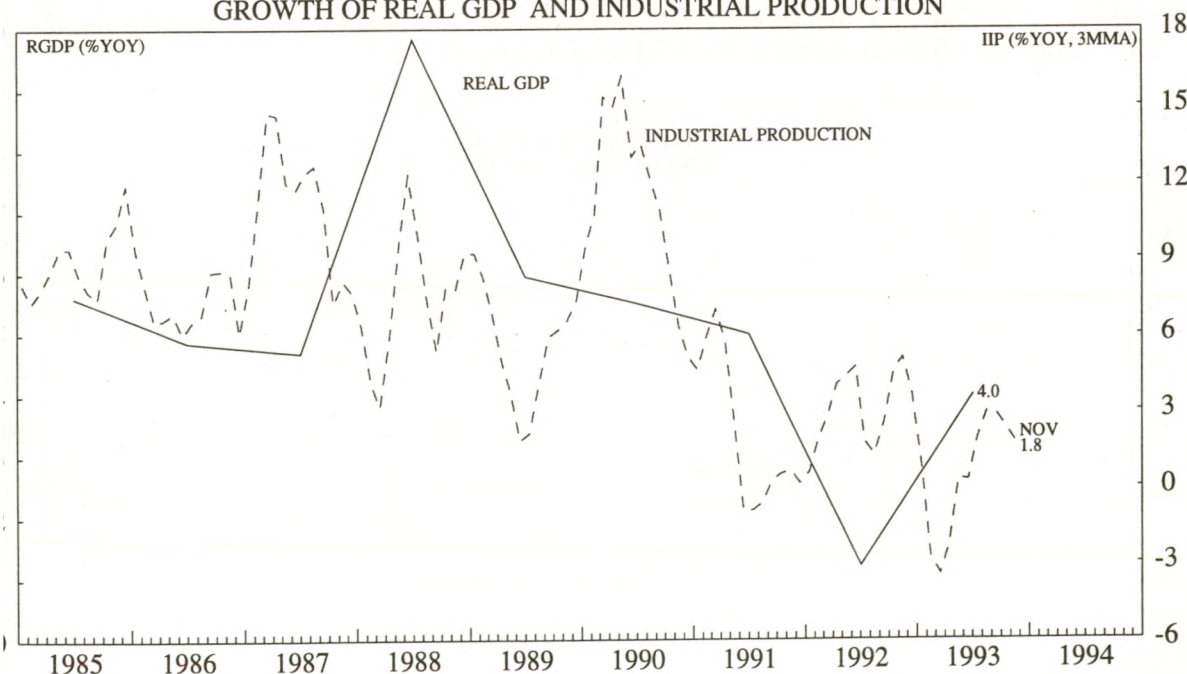
SOURCE: RESERVES BANK OF INDIA BULLETIN

18 MAR 94

- (i) A lower basic corporation tax, cut from 45% to 40% with no change in the 15% surcharge. This reduces the effective tax on corporate entities from 51.7% to 46%.
- (ii) An extended excise tax (MODVAT) which now encompasses capital goods and petroleum products. This is a centrally collected tax and is levied in addition to the local states sales taxes. The continuous move to make more of the excise taxes ad valorem in nature will ensure that tax revenues are more inflation linked than in the past. Around 80% of excise taxes are now ad valorem.
- (iii) Lower peak levels of import tariffs from 85% to 65% so that the average tariff rate falls from 35% to 25%. Imported raw materials and components in particular will become much cheaper to import. This measure may give a one off boost import growth over the forthcoming year.

In addition to these measures, in his budget speech the Finance Minister announced that the Rupee would be made almost fully convertible on the current account this year. The tourist allowance was raised to \$2000 and foreign exchange is to be made available for medical treatment and education abroad. Lastly he stated that commercial banks lending rates would be cut by 1% to 14%. This is the latest in a long line of interest rate cuts which began in 1992. (Chart 4)

INDIA: CHART 3
GROWTH OF REAL GDP AND INDUSTRIAL PRODUCTION

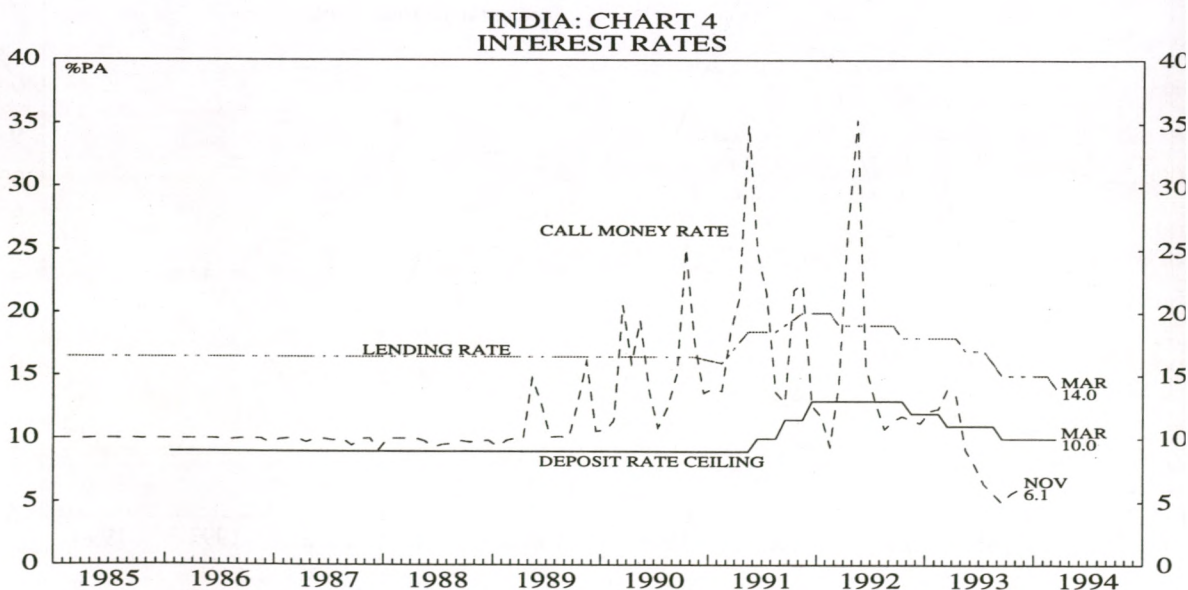


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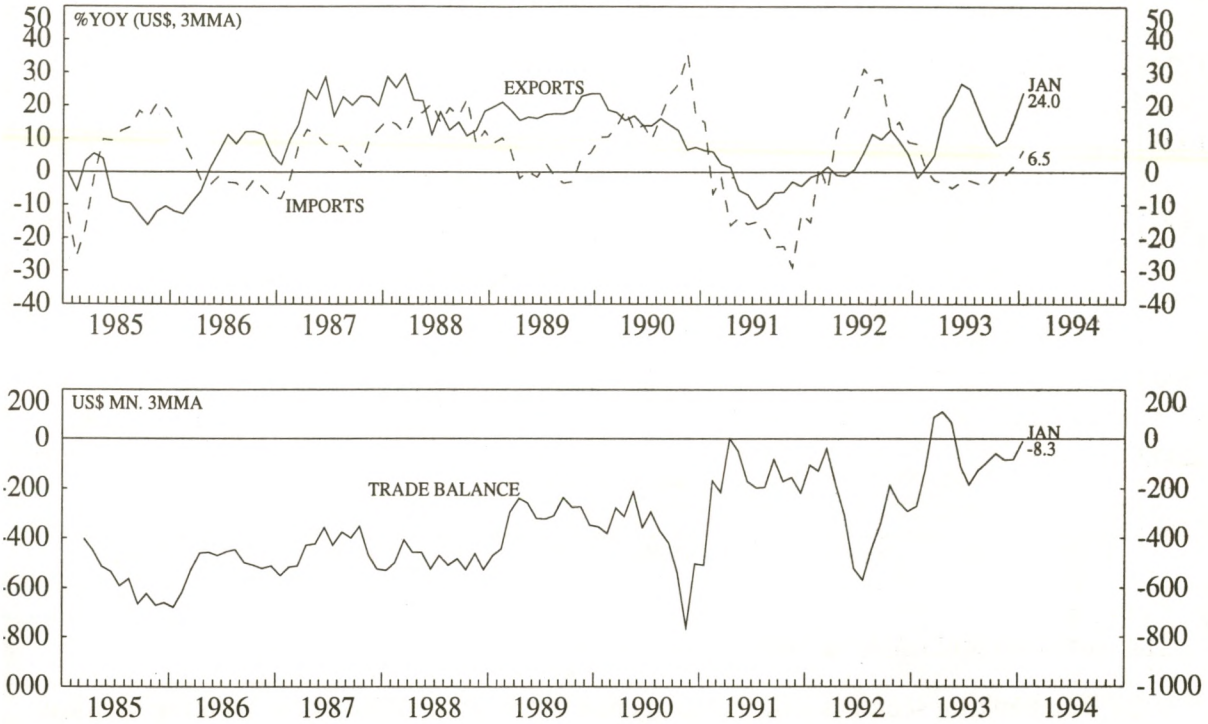
The External Accounts

The overall balance of payments position has improved rapidly over the last 12-18 months (contributing to an upturn in the monetary base). This is due to two main factors. First there has been a continuous improvement in the trade deficit (Chart 5). For the year ending November 1993 it narrowed to US\$0.8 billion from over US\$3 billion for the year to November 1992. While exports have averaged above 10% growth over 1993, import growth has remained slack reflecting the slow recovery from the slump in economic activity. However the recent reductions in tariffs together with stronger domestic demand in the year ahead will raise import demand. Prospects for faster export growth may improve later in the year in response to a stronger recovery in parts of Europe -- 25% of Indian exports are destined for Europe. Nevertheless the trade balance is unlikely to show a substantial improvement over the next year.

The second more noticeable factor which has served to boost foreign exchange reserves at the RBI is the continued increase in foreign portfolio and direct investment flows into India (Chart 6). The Finance Minister has approved around US\$2.6 bn worth of overseas debt and equity for the fiscal year 1993-94. Given the RBI's policy of keeping the Rupee/US\$ rate at around 31.4 the upward pressure on the currency has translated into a significant increase in foreign exchange reserves at the RBI (Chart 7). The government is unlikely to allow the Rupee to appreciate since it is keen to preserve the current level of export price competitiveness. Large corporates continue to raise funds from abroad taking advantage of the relatively low cost of funds in the developed capital markets. However the Finance Ministry is becoming increasingly reluctant to continue to approve these fresh capital inflows where they involve bond issues since it is apprehensive about future debt obligations. If the Finance Ministry does reduce the rate at which it approves foreign investment, the upward pressure on the currency would not be so great. As a result the RBI would not have to intervene in the foreign exchange market quite as heavily and the accumulation of foreign assets at the RBI would slow down.

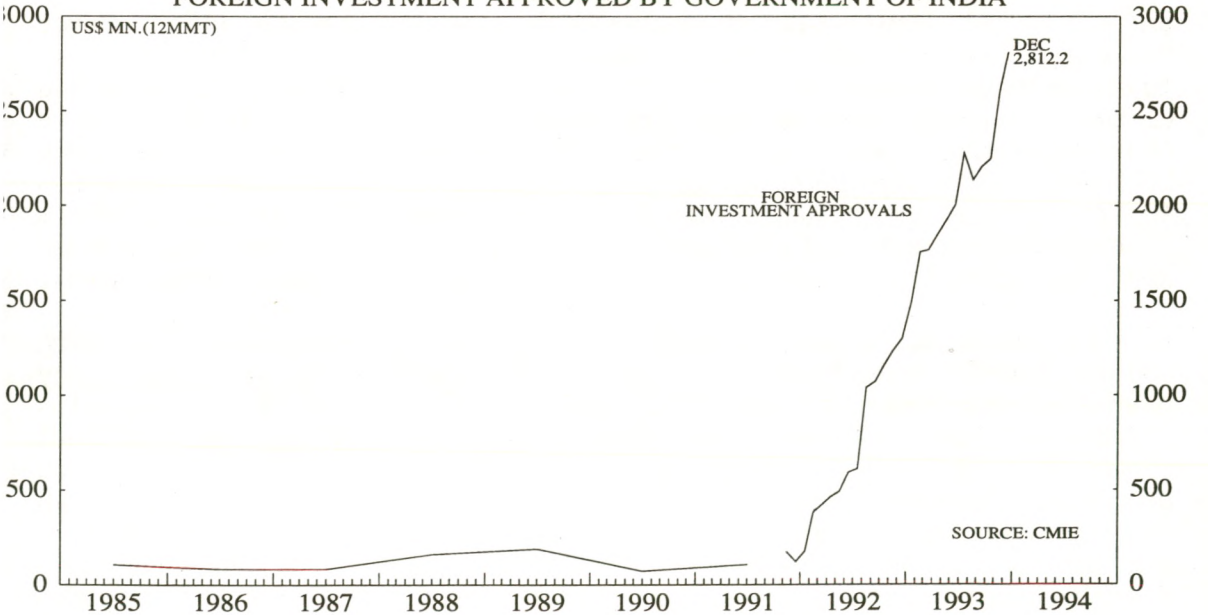


INDIA: CHART 5
TRADE PERFORMANCE



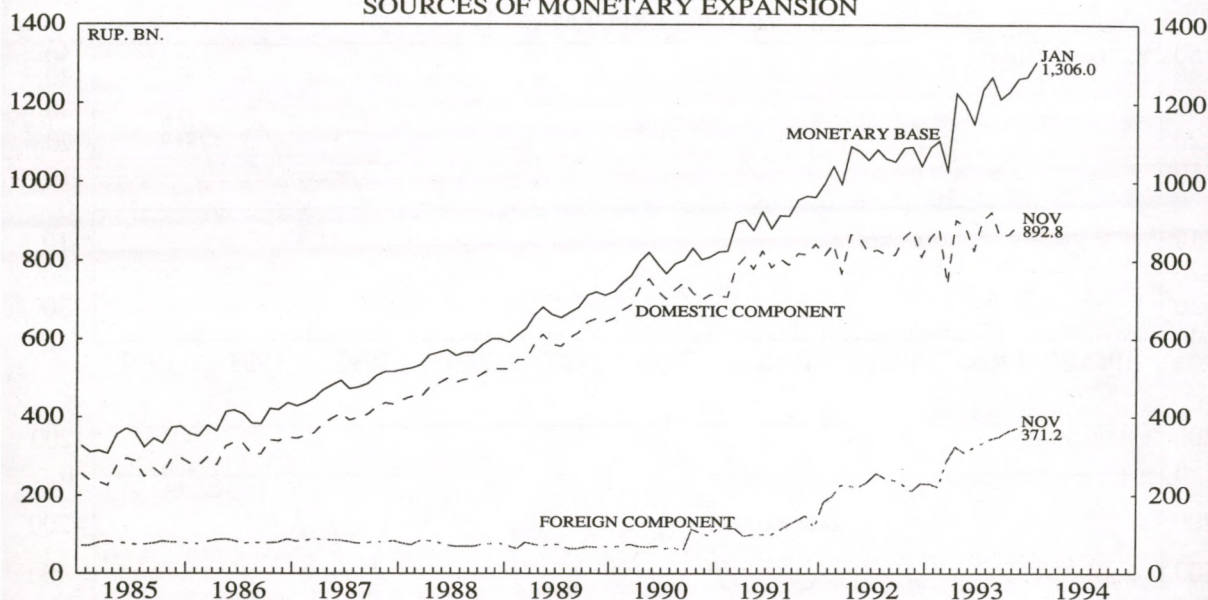
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INDIA: CHART 6
FOREIGN INVESTMENT APPROVED BY GOVERNMENT OF INDIA



21 MAR 94

INDIA: CHART 7
SOURCES OF MONETARY EXPANSION



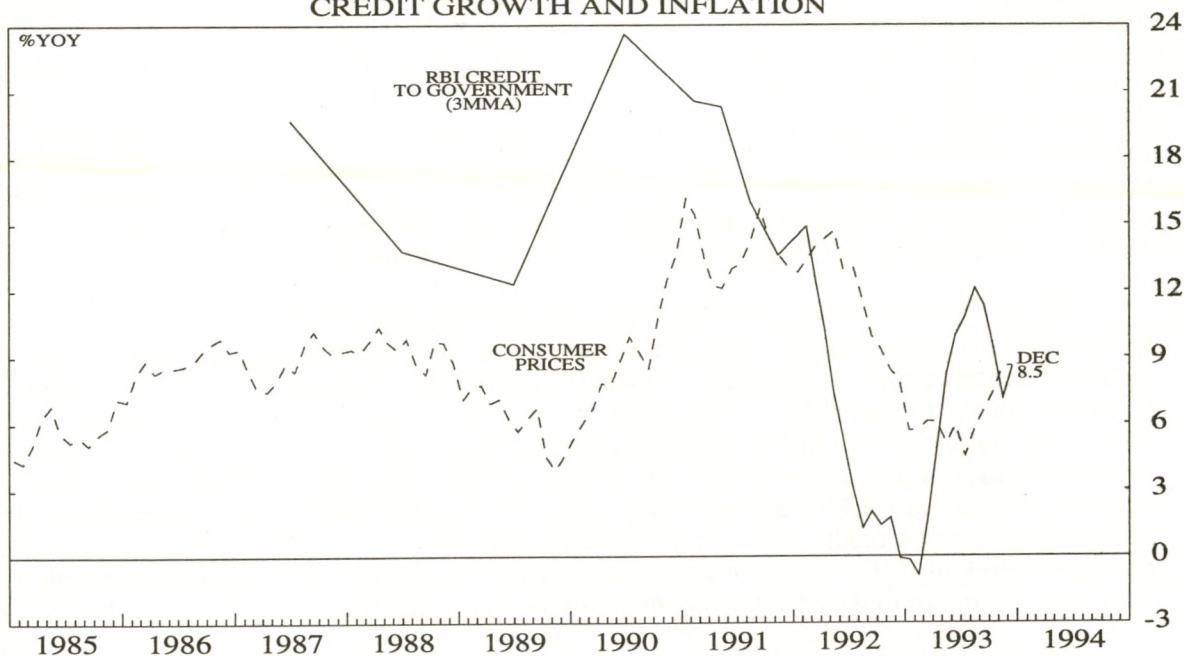
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The Monetary and Banking Sector

The banking sector is still on the agenda for reform. Most of the banking sector is state owned and operates under strict controls on its assets that favour the holding of government debt. Unfortunately there are no imminent plans to reform this aspect of banks operations despite the current attempt to introduce greater competition in the banking system. Most recently the RBI granted licences to 9 new privately owned banks which will open for business this April. The RBI has specified that 60% of each bank's equity must be privately owned. However the introduction of these new banks will do little to reduce banking spreads or the cost of capital. This is because (1) the RBI will continue to set guidelines for deposit and lending rates to be followed by both public and private banks and (2) these new private banks are to be subject to the same high cash and liquidity reserve ratios and priority sector lending restrictions as the existing state owned banks. Mandatory holdings of cash and government debt eat up around 48% of their deposits. In addition 40% of what is left is still state directed lending to "priority" sectors (which include the agricultural sector and small producers). With this kind of structure imposed on banks assets there seems little prospect of a decline in bank spreads (i.e. lending-deposit rates).

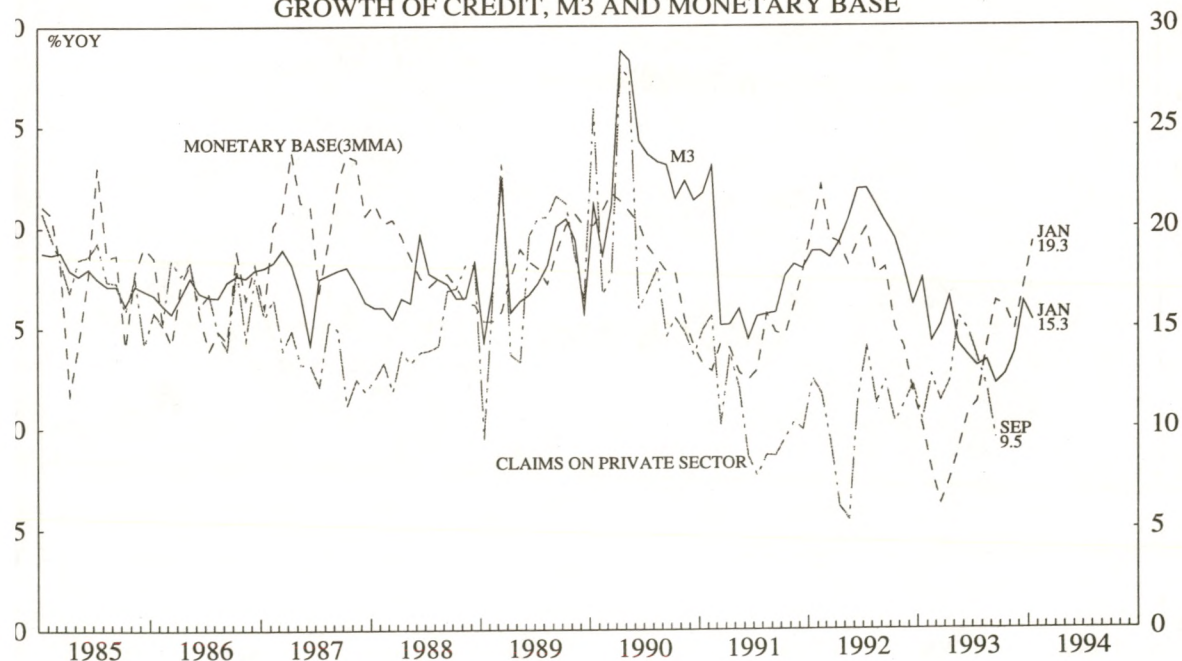
Capital adequacy ratios (CAR) have recently been imposed on the commercial banks, and are required to be met by domestic banks by 1996. In addition they have had to deploy more stringent provisioning for poorly performing loans. In particular loans classified as "substandard" require a 40% provision, "doubtful" debts require a 60% provision and "bad" debts a 100% provision. Official estimates of the total of substandard, doubtful and bad debts held by the banks range between 20-30% of all their private sector loans. The overall cost of provision has reduced the expansion of private sector loans. Consequently government debt - which carries a zero weight in the CAR calculation - has become more attractive to banks at a time when their reserves have been rising. 10 year government debt yields around 13.3% while lending rates charged to large corporations range from 14 to 17%.

INDIA: CHART 8
CREDIT GROWTH AND INFLATION



17 MAR 94

INDIA: CHART 9
GROWTH OF CREDIT, M3 AND MONETARY BASE

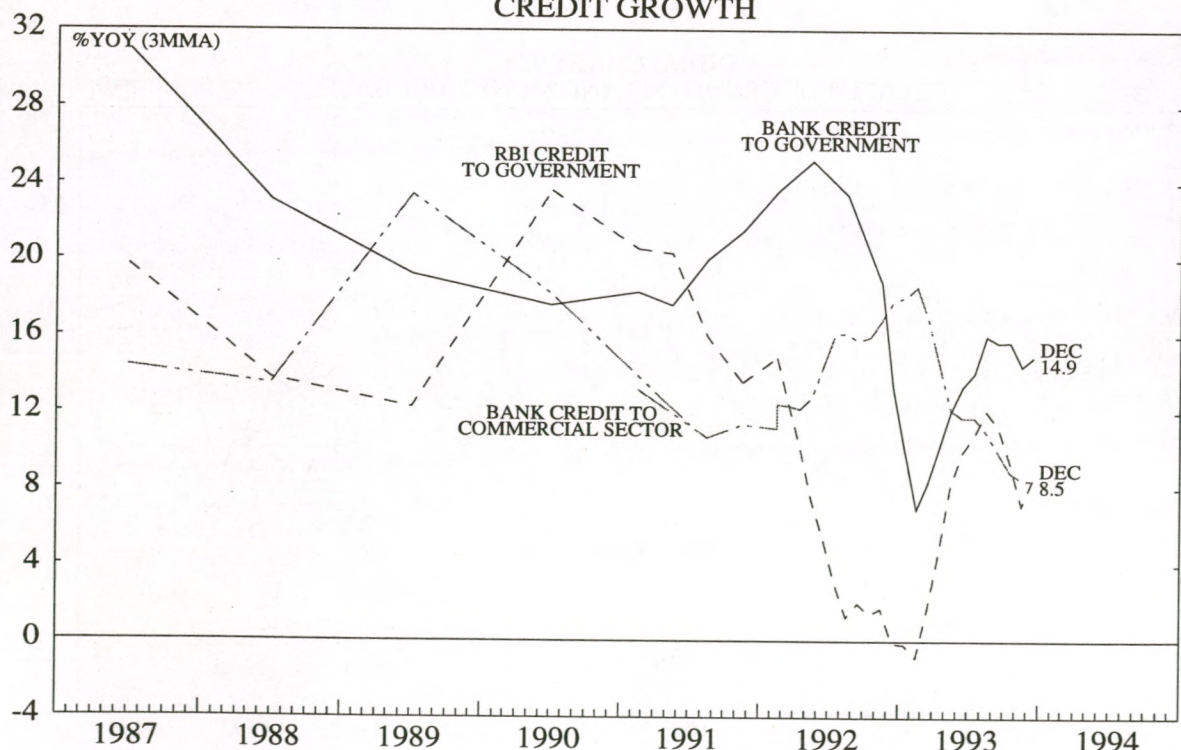


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The expansion in the fiscal deficit over 1993-94 and the projected deficit over 1994-95 have sparked fears that the government may turn on the money printing press to finance its planned excess spending (Chart 8). This is something that the Indian government has resorted to in the past, the most recent example occurring in 1989-90. In an effort to curb the ever present tendency of the government to monetise its deficits, the Finance Minister has placed a Rs 60 bn maximum limit on the outstanding RBI ad-hoc purchases of government debt over the 1994-95 fiscal year. If adhered to this may induce a greater element of stability in the domestic component of the monetary base. In the year to December 1993 RBI claims on the government rose by Rs 111 bn (12%) whereas the year ending January 1993 saw RBI claims on the government up only Rs 38 bn (4%).

The growth rate of the monetary base has accelerated over 1993, not because of an increase in the domestic assets of the RBI (from financing government spending) but from the rapid expansion in foreign exchange reserves (Chart 9). This has recently led to a turn around in (broad money) M3 whose growth has accelerated from around 12% mid year to 16% by December (Chart 10). Commercial bank credit to the government which accounts for around 40% of M3, grew 16% yoy in January 1994. By contrast private sector credit which accounts for 45% of M3 grew by only 8% over the same period. The different growth rates in these bank assets reflects the low demand for credit at the domestic interest rates prevailing in 1993, the ongoing provisions for poorly performing private loans which banks are having to make and the expansion in the fiscal deficit.

INDIA: CHART 10
CREDIT GROWTH



The overall monetary stance is therefore improving with most of the expansion in broad money deposits being created through faster credit growth to the government. This trend will continue through 1994 since (i) the government does not envisage a significant cut in its fiscal deficit for 1994-95 and (ii) the bad and doubtful debt management problems will linger for some time to come. However private sector credit growth will strengthen as more firms adjust their borrowing requirements to the current downswing in lending rates which started in January 1992. Moreover if corporate entities continue to borrow from abroad over 1994 relatively unhindered, further cuts in domestic interest rates would be possible at the current exchange rate.

CONCLUSION: 1994 will be a year of recovery in India, the speed of which will determine whether the government meets its fiscal deficit target for 1994-95. Official expectations are for the fiscal deficit to fall by 6%. However economic growth of South East Asian magnitudes will not be possible without a substantial scaling down of the public sector. This will have to be done in the next few years if the government is to reduce its fiscal deficit and institute more significant bank liberalisation reforms. Import growth will likely accelerate on the back of an upturn in the real economy and in response to the recent tariff liberalisation measures.

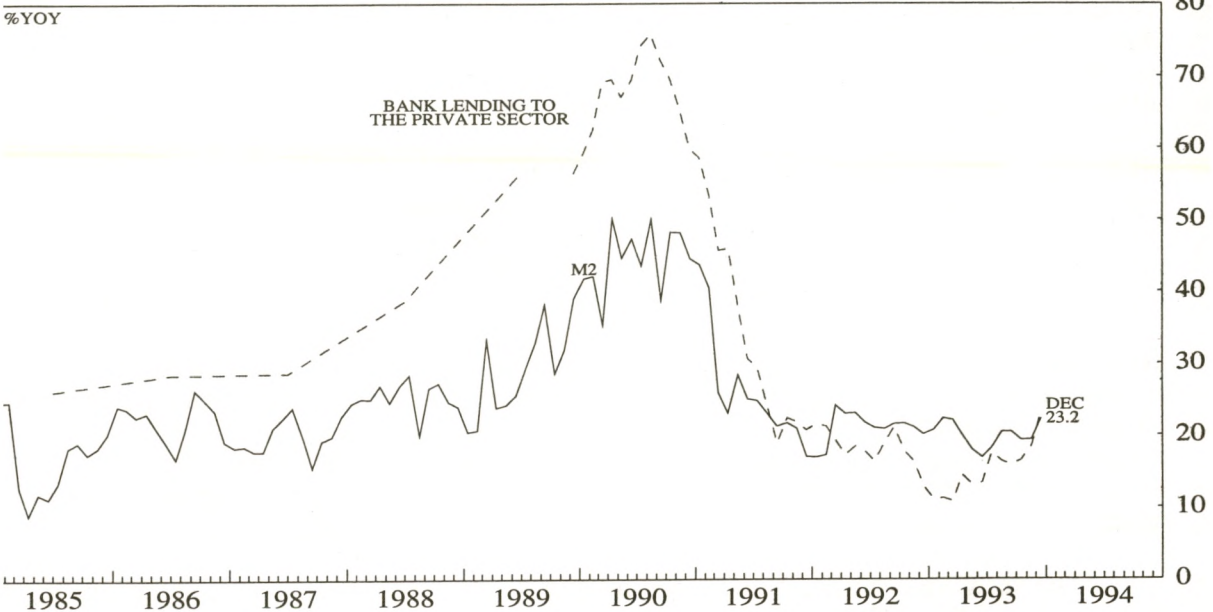
Although constrained by the structure of banks balance sheets and ongoing bad debt provisions, domestic private sector credit growth will show a modest upturn as loan demand responds to the downward trend in interest rates over the past two years. Meanwhile government debt will continue to provide much of the overall expansion in asset growth of commercial banks. Continued access to foreign capital will provide fuel for faster broad and reserve money growth at the current exchange rate although this source may begin to dry up if the authorities do reduce the rate at which they approve foreign investment. The stronger monetary growth in prospect makes for a positive environment for equities although there will be upward pressure on inflation (now at around 8-9%) later in 1994. Food price shocks are unlikely to dramatically raise the cost of living this year because grain stocks are more than sufficient to satisfy domestic demand should the forthcoming monsoon prove to be disappointing.

INDONESIA POLICY CHOICES FOR THE ECONOMIC UPSWING

Following a protracted spell of painful economic adjustment, the Indonesian economy has been exhibiting clear signs of acceleration since the middle of 1993. A range of indicators including lending growth, car sales and imports are pointing firmly upward while anecdotal evidence provides tales of stronger investment and consumption expenditures. (The paucity and tardiness of real economic data compels us to rely on snippets gleaned at the microeconomic level.) With economic expansion now firmly underpinned, the task facing the authorities is how to manage the upturn to prevent the recurrence of the boom-bust cycle of 1988-92. Two major issues are currently concerning policy makers: inflationary pressures in the property sector and weakness in export growth. However, confronting the two issues simultaneously involves conflicting policy choices. The former requires a slightly tighter monetary policy in order to check the over-enthusiasm of a still immature banking system and prevent another blow-out in credit extension. This in turn could lead to further upward pressure on the currency (see AMM Vol. 17 No. 3) but Rupiah strength would undermine the latter task of stimulating exports. At the time of writing, the authorities seem more concerned with export growth and thus policy is likely to remain accommodatory. Such a track is positive for asset markets in the near term but could easily end in tears a la 1990. Nevertheless, the technocrats now seem to recognise that smooth, sustained upturns are preferable to episodes of boom-bust so the chances of pre-emptive action are still reasonably good. Whether their political masters will allow such action is a different question.

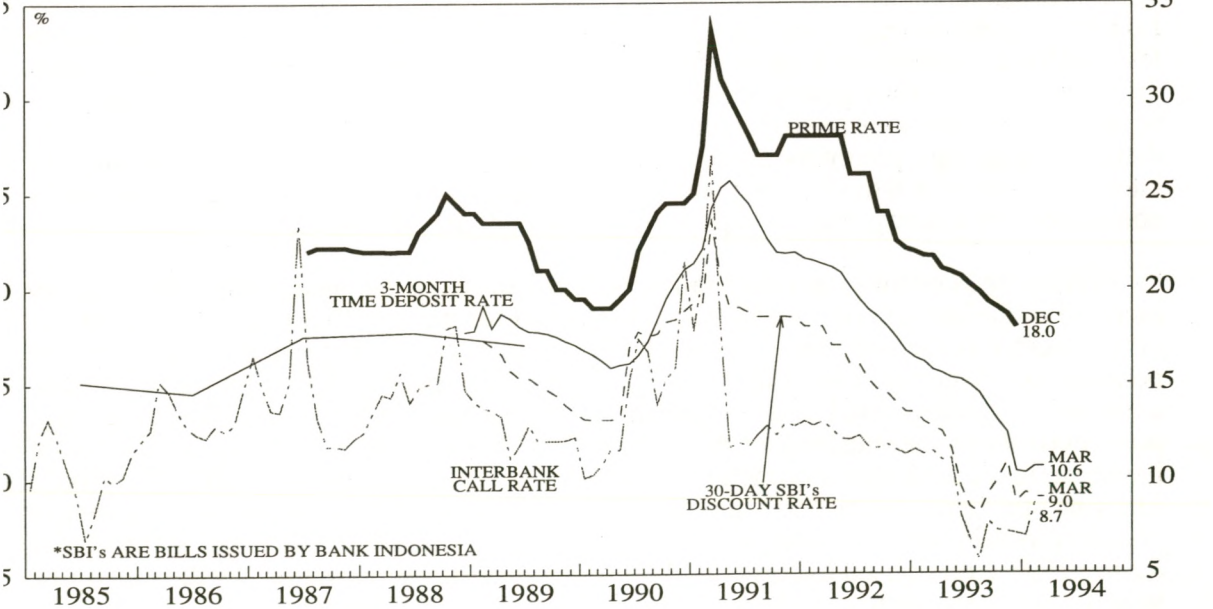
Following two years of very tight monetary policy, Bank Indonesia (BI) started to express concerns in early 1993 that bank lending was expanding at a rate below the level it considered appropriate for its economic growth targets (Chart 1). Bank lending to the private sector had fallen from a peak of over 70% yoy during 1990 to a low of 10.8% yoy by March 1993, and was well below the rate of M2 growth which had stabilised at around 20% yoy. This divergence was, in turn, a function of BI policies directed towards restoring the integrity of the banking system. As detailed in previous AMMs, the Pakfeb of February 1991, had introduced a series of prudential regulations governing Capital Adequacy Ratios, Loan/Deposit Ratios, directional lending targets, etc. However, the weakness of the banking system was extreme. Reliable figures for non-performing loans have never been published due to their political sensitivity; the governor of BI has admitted a figure of Rp 2.54 trillion in the state banks (3.7% of their total loans) and Rp 1.14 trillion in the private national banks (2.7% of their total loans), but the true figure is probably considerably higher. Moreover capital levels were extremely low -- the deregulation package of 1988 had allowed anyone with capital of US\$1 million to set up a bank. It was therefore necessary for BI to offer help to the banks in meeting their targets and rebuilding their capital, or systematic failure could have been the outcome. This help was provided in two ways. First, BI issued Rp 59.2 and Rp 61.9 trillion of Bank Indonesia Certificates (SBIs) during 1991 and 1992 respectively while the outstanding amount rose from Rp 1.5 trillion at the end of 1990 to Rp 23.7 trillion by February 1993. More importantly, this central bank paper was issued at a rate in excess of interbank funding costs (Chart 2) and not far below deposit funding costs. The former trade (borrow interbank, lend to BI) yielded an instant clear profit; the latter trade (fund at deposit rates, lend to BI) a small loss but at effectively no risk in contrast to the higher default danger of issuing a new loan. In addition to this direct subsidy, BI allowed the banks to maintain huge lending rate spreads for the residual assets which (subject to the loan performing) also helped to rebuild capital at a rapid pace.

INDONESIA: CHART 1
MONEY SUPPLY AND BANK LENDING TO THE PRIVATE SECTOR



16 M

INDONESIA: CHART 2
INTEREST RATES



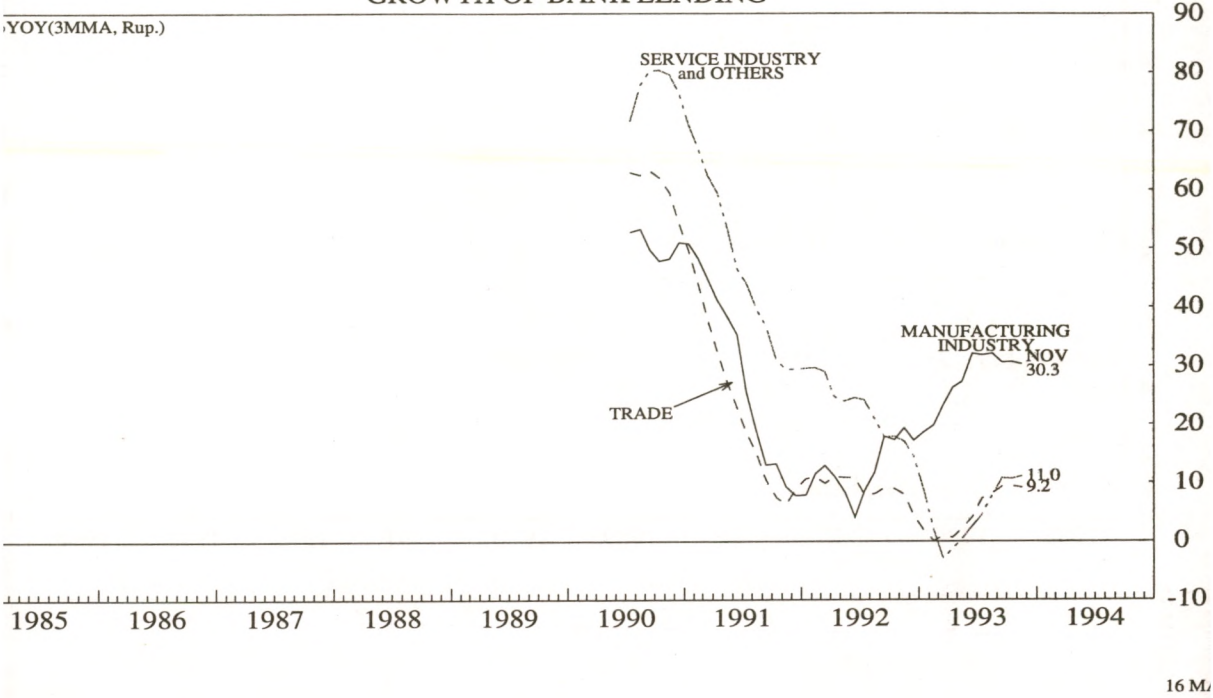
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Policy changed in early 1993 and was formalised with the announcement of Pakmei on 29th May. The loan growth nadir of 10.8% yoy was well below BI's 17% target so SBI issues were rapidly curtailed and the amount outstanding fell Rp 6.2 trillion over February-July. (SBIs outstanding have since risen again sharply but this has been for balance of payments reasons. See Chart 11 in the later part of this article.) At the same time, the rates offered on SBIs were also lowered significantly widening the discount to deposit rates and thus diminishing the (risk-adjusted) attractiveness of buying paper. The effect was almost instantaneous. Bank lending growth shot up (to 18.5% yoy in November) and the concern is now that institutions have not learnt from their experience of recent years and are destined to repeat their mistakes of the past. The loan growth has been extremely lopsided being concentrated in export finance and more significantly (in terms of growth) in housing finance (Chart 3) which is included in loans to manufacturing. Lower interest rates can explain this surge in part but of greater importance has been changes announced in Pakmei. The percentage of total loans to be allocated to small businesses remains at 20% but any small loan (under Rp 25 million) can now be counted as a small business loan. Moreover, collateralised mortgage lending is a relatively safe way for banks to meet their allocation targets. This trend is also clearly visible in the domestic investment approval figures (Chart 4). Investment growth remains sluggish and is still declining slightly in the largest industrial category. However, housing investment has more than doubled since 1992.

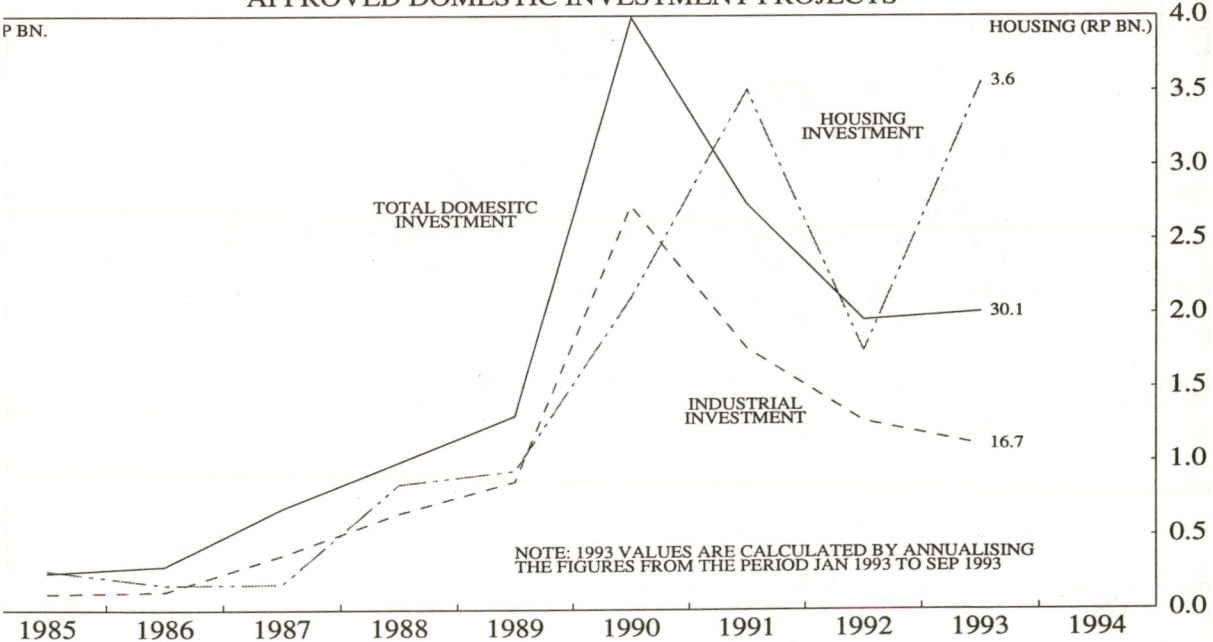
The negative symptom of the surge in housing finance has been a surge in the housing component of the CPI (Chart 5). Rising property and construction material prices are reflected in the 16.6% annual rate of increase in the housing CPI as at December 1993. This represents a 4.4% contribution to inflation given housing's 26.6% weighting in the CPI basket. By contrast, food prices (34.2% of the basket) are only rising 5.1% yoy while the residual of the basket was up 10.3% yoy at the end of December. Food prices are likely to be strong in early 1994 due to factors associated with Chinese New Year and various religious festivals, but the residual is expected to fall sharply in early 1994 as transport, telecommunication and fuel price rises announced in early 1993 drop out of the figures. Lower fuel cost increases will also show up in a slight fall in the housing CPI. Nevertheless, with the economy picking up speed, controlling inflationary expectations and a banking system that has shown little self-discipline in the past, may well be difficult. It is hard to envisage the authorities raising interest rates at the current time as this could undermine their exchange rate policy by attracting additional capital inflows (more on this subject later). However, it would be prudent for BI to step up its recent warnings to the banks about property lending, and perhaps to retighten lending restrictions.

Already as interest rates have fallen, M1 growth has accelerated sharply signalling an increase in the speculative and transaction demand for money (Chart 6). The former has been reflected in the booming equity and property markets; the latter in rising imports and personal consumption. As Alan Greenspan has noted, once inflation has appeared and expectations are ingrained, policy action has to be that much more severe. BI can act now, pre-emptively by the standards of ASEAN (with apologies to Singapore), or run the risk of having to instigate a bigger crunch in late 1994 early 1995. Such action would have been likely had the situation arisen six months ago but unfortunately, BI is now working under a policy constraint of weaker export growth (Chart 7). Total US dollar exports grew 8.4% during 1993 with non-oil exports (NOEs) expanding 16.2%. However, by the end of the year, total exports were contracting while NOE growth had slowed to single digits. The talk from the politicians and certain areas of the bureaucracy now concerns loss of competitiveness and thus the inflation issue has been pushed to a back burner.

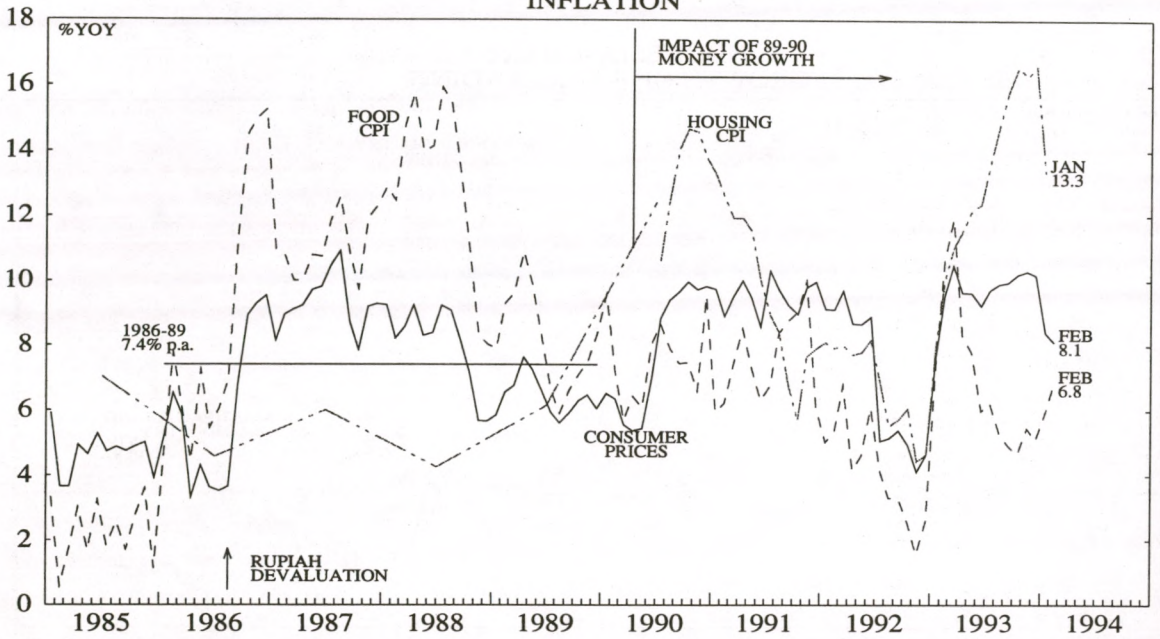
INDONESIA: CHART 3
GROWTH OF BANK LENDING



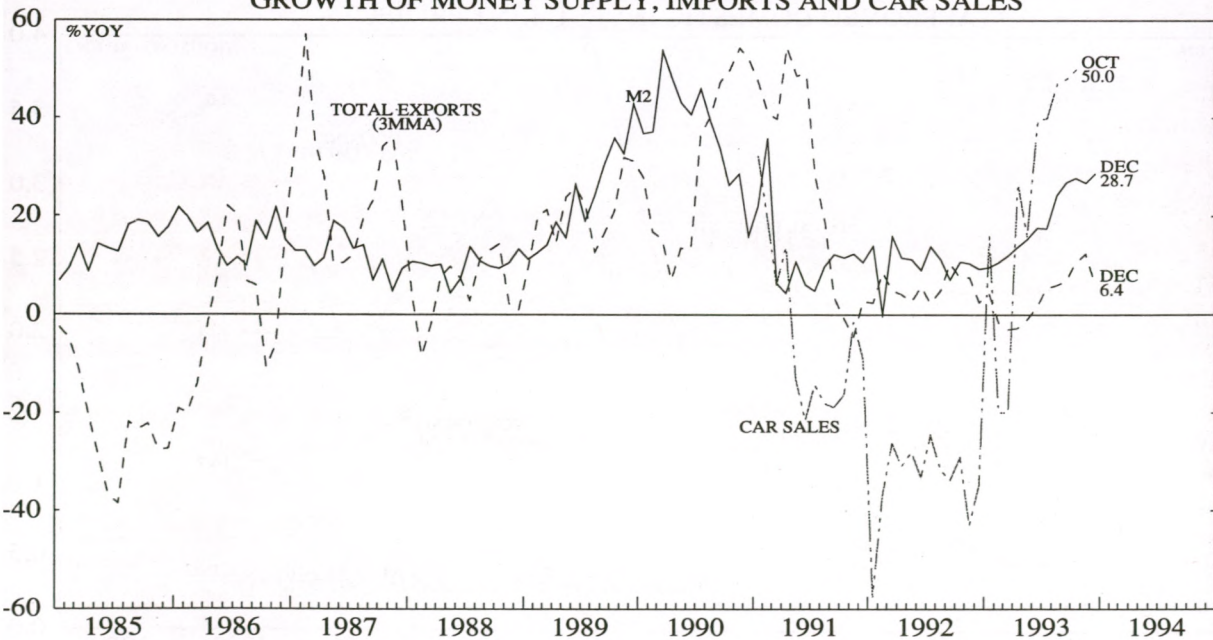
INDONESIA: CHART 4
APPROVED DOMESTIC INVESTMENT PROJECTS



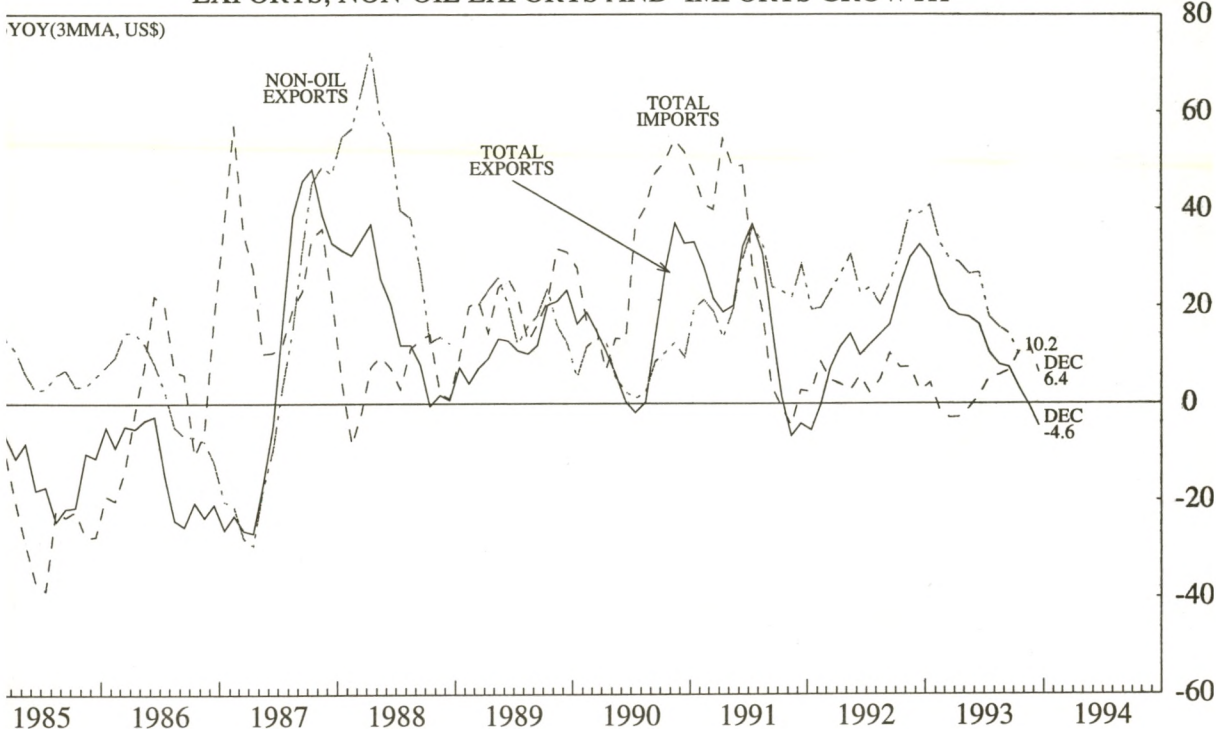
INDONESIA: CHART 5
INFLATION



INDONESIA: CHART 6
GROWTH OF MONEY SUPPLY, IMPORTS AND CAR SALES



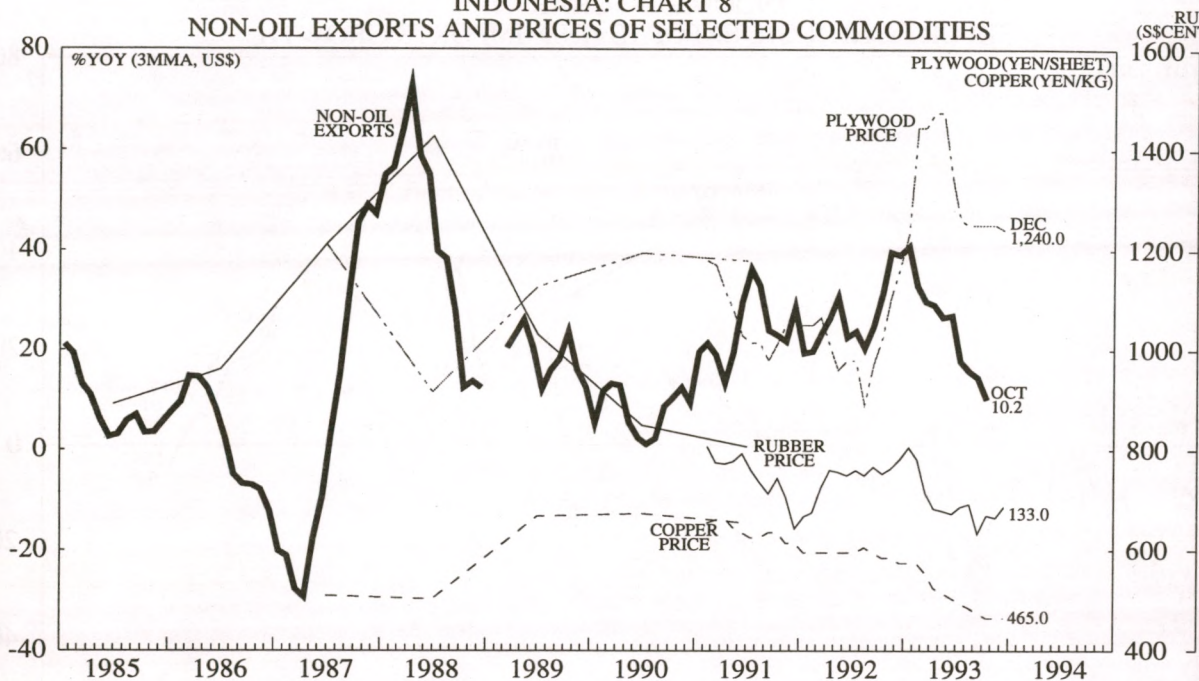
INDONESIA: CHART 7
EXPORTS, NON-OIL EXPORTS AND IMPORTS GROWTH



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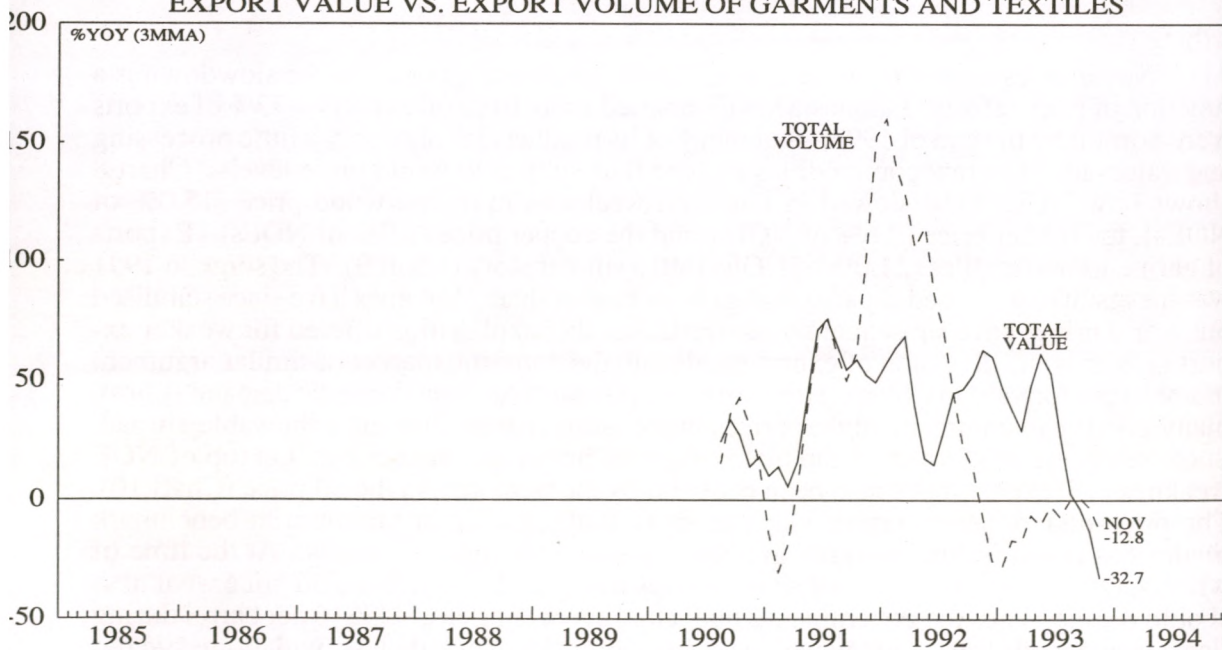
Nevertheless, some of this concern may be misplaced as much of the slowdown is a function of price effects. Indonesia has diversified away from oil exports -- 73% of exports were non-oil by the end of 1993 -- but many of its products involve only a little processing and value-added to raw commodities and are thus subject to world price levels. Chart 8 shows how NOEs have slowed in line with weakness in the plywood price (15.0% of NOEs), the rubber price (3.6% of NOEs) and the copper price (2.7% of NOEs). Exports of garments and textiles (21.0% of NOEs) tell a similar story (Chart 9). The surge in 1991 was the result of increased capacity and gains in market share. Volumes have since stabilised out world prices have subsequently plunged. Another explanation offered for weaker export growth is the diversion of export goods into the domestic market (a similar argument has been put forward in China). High tariff levels mean that when domestic demand is firm, many goods can command higher prices in the home market than are achievable abroad. Such trends are reinforced all the more, if global prices are weakening. On top of NOE weakness, oil exports have also been badly hit by the weakness in the oil price (Chart 10). The price of Indonesian crude which tends to trade at a slight premium to benchmark grades has fallen in line resulting in a sharp contraction in oil revenues. At the time of writing, OPEC seems no nearer than ever to resolving its differences so oil price weakness should persist. Thus the government's budgetted average price of US\$16 per barrel during fiscal year March 1994-95 may well be over-optimistic. Nevertheless, with domestic demand likely to surprise on the upside, any undershoot should be offset by increases in other sources of revenue.

INDONESIA: CHART 8
NON-OIL EXPORTS AND PRICES OF SELECTED COMMODITIES

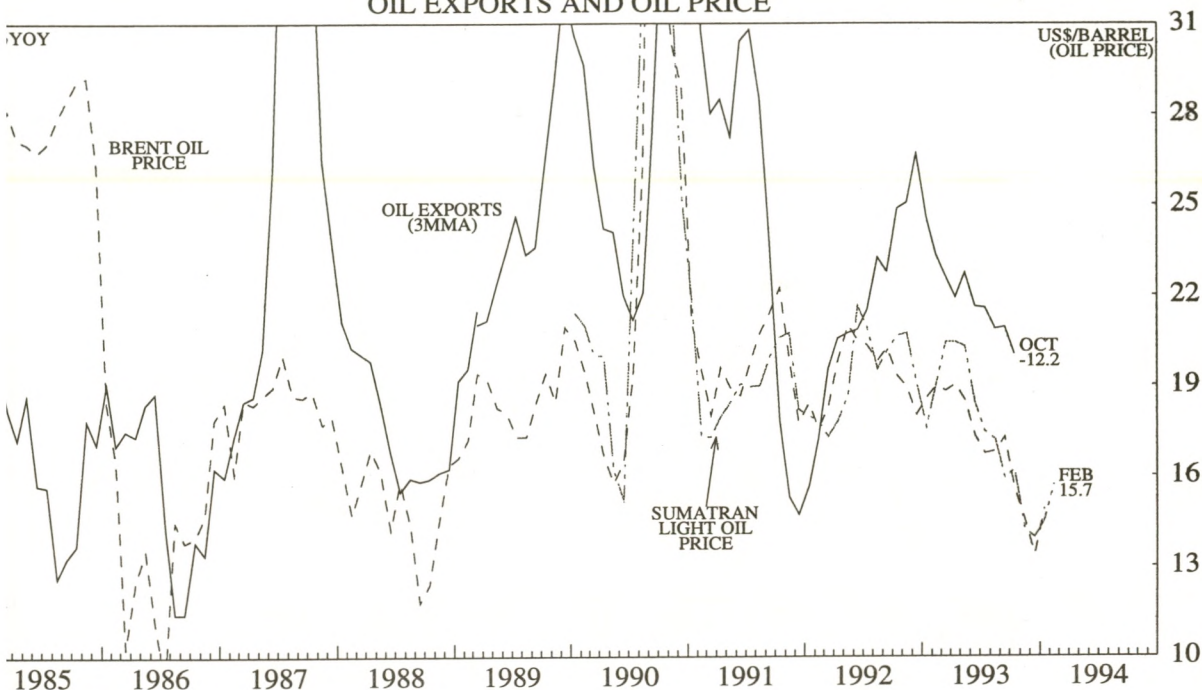


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INDONESIA: CHART 9
EXPORT VALUE VS. EXPORT VOLUME OF GARMENTS AND TEXTILES



INDONESIA: CHART 10
OIL EXPORTS AND OIL PRICE

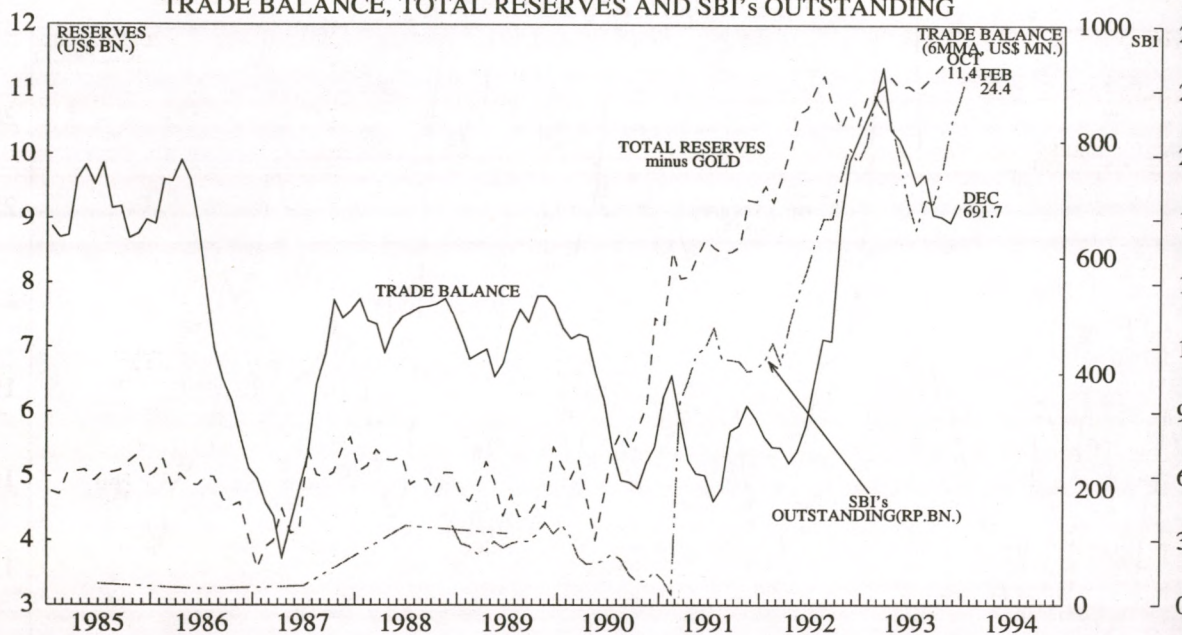


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The slowdown in export growth combined with the rise in import growth has contributed to a narrowing in the trade surplus but this remains significantly in surplus (Chart 11). Furthermore, short and long term capital inflows are still strong. Direct inward investment, although down from its peak, remains comfortably positive (US\$5.7 billion approved in the 9 months to September 1993) while the stockmarket and interest rate arbitrage opportunities continue to attract foreign capital. As a result, BI has been obliged to start issuing SBIs once again in an attempt to sterilise these inflows. As discussed above, BI started to retire SBIs at the beginning of 1993 in order to encourage a resumption of bank lending. However, a stronger balance of payments and faster credit growth have necessitated a reversal of policy.

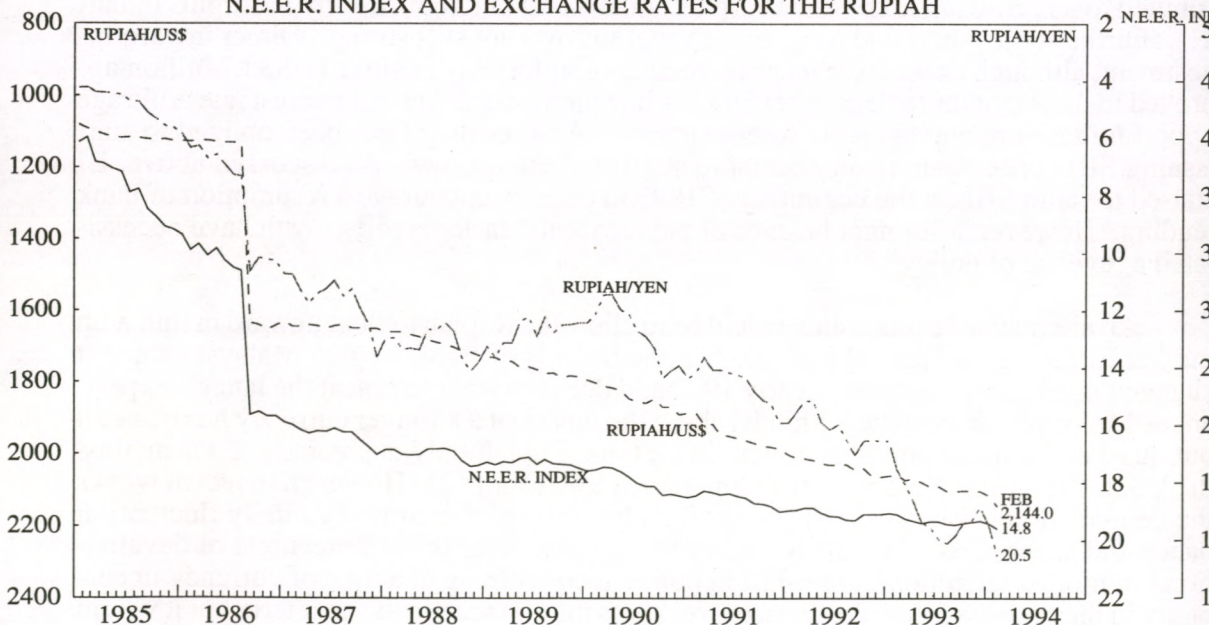
An alternative to this policy would be to allow the Rupiah to float upward in line with market forces. However, BI has watched the travails of Bank Negara Malaysia since it changed market expectations in early 1992 and does not want to repeat the latter's experience. Moreover, any debate within BI about the merits of a stronger currency has been all but quashed by the export slowdown. In fact, the Rupiah only depreciated 2.3% against the US dollar during 1993 against a trend rate of 5% (Chart 12). However, in recent weeks the depreciation has been speeded up and BI has relaxed the currency's daily fluctuation bands and abandoned one of its two daily fixing rates. This is not a precursor of devaluation but more a reflection of the shift in policy focus coming at a time of currency uncertainty in the region as a whole. Further weakness may be seen in the near term but it would be extremely surprising if the depreciation for the whole of 1994 exceeds 5%. Aside from the danger of precipitating a significant short term capital outflow, the imported component of inflation would rise in the current environment of accommodatory monetary policy.

INDONESIA: CHART 11
TRADE BALANCE, TOTAL RESERVES AND SBI's OUTSTANDING



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INDONESIA: CHART 12
N.E.E.R. INDEX AND EXCHANGE RATES FOR THE RUPIAH

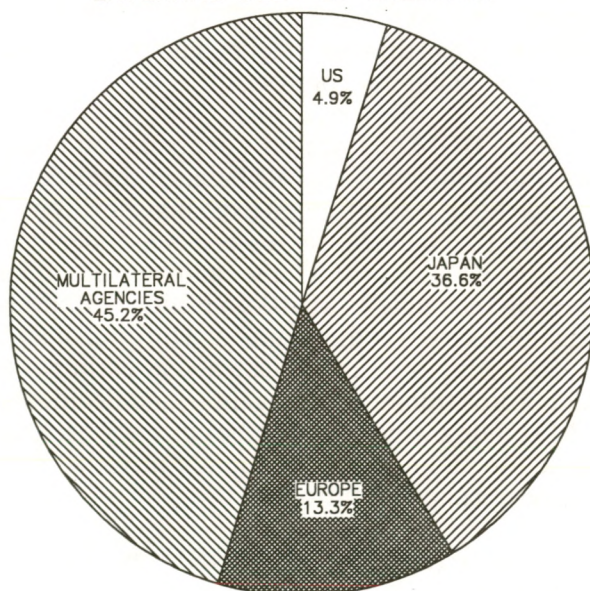


17 Mar, 94

Another argument against faster depreciation is that it would add to the debt service on Indonesia's US\$48.9 billion foreign debt (Chart 13, as at March 1993). The debt service to export earnings ratio stood at 19.0% at March 1993 but the structure of this debt is somewhat unusual. 36.6% of debt is Yen-denominated while only 28.6% of total exports and 16.5% of NOEs go to Japan. Around 50% of debt is US dollar-denominated while the rest is denominated in various European currencies. At current exchange rates, the Rupiah is over 20% lower against the Yen than it was at the beginning of 1993. It has depreciated over 50% against the Yen since 1990 compared to a 17% depreciation against the greenback. Although debt service is by no means unmanageable, a crawling dollar peg is far from ideal given the size of Indonesia's Yen-denominated obligations.

CONCLUSION: With Indonesia entering the upswing of the business cycle, the challenge for the authorities will be to avoid another blow-out in credit supply and a repeat of the 1988-92 episode of boom-bust. Two major issues are currently concerning policy makers: inflationary pressures in the property sector and weakness in export growth. Of the two, the former is probably the more serious but attention is being focused on the latter. This implies no reversal of Indonesia's cheap currency policy in the near term. Indeed Rupiah depreciation could be accelerated slightly in an attempt to boost export growth. However, property price inflation is a concern insofar as it helps to ingrain generalised inflationary expectations in the economy. In the absence of self-regulation, the banks need to be instructed more forcibly to restrict their lending to real estate. Indeed, a reintroduction of some of the regulations relaxed in Pakmei would probably be appropriate at this stage. The authorities therefore face a range of policy choices over 1994 but if they choose to focus on weak exports -- something over which they have little real control -- then monetary policy is likely to remain too loose. This bodes well for liquidity and asset prices over the coming months but considerably diminishes the chances of a smooth, sustained economic upswing.

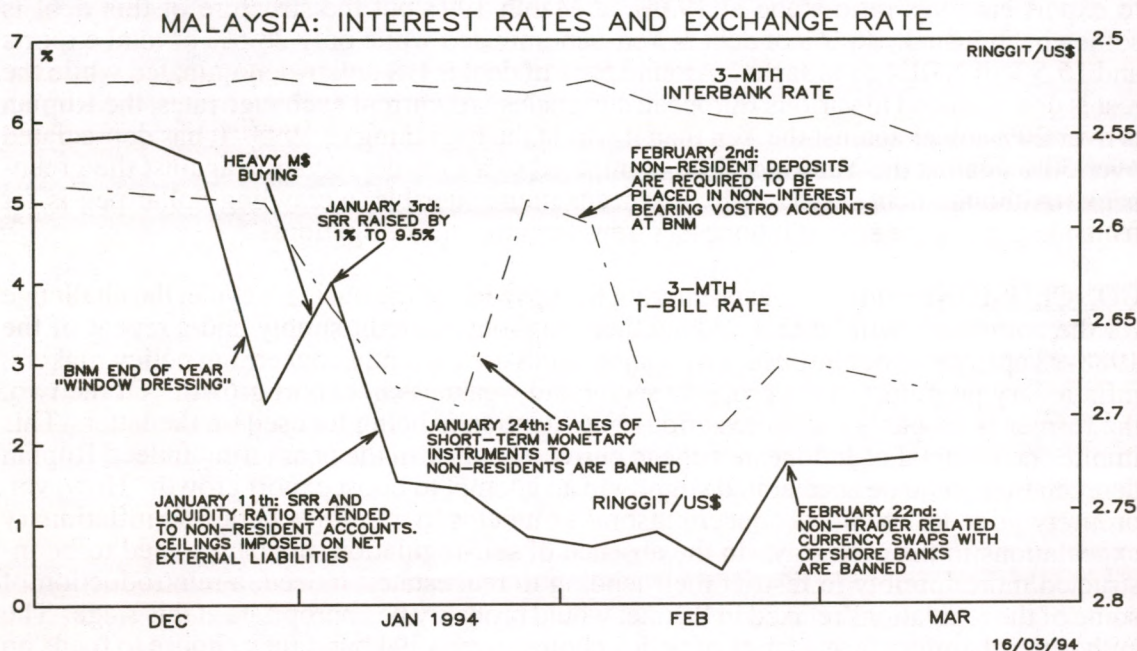
INDONESIA: CHART 13
EXTERNAL DEBT BY CREDITOR



TOTAL EXTERNAL DEBT: US\$ 48.9 BN., MARCH 1993

4 Mar 94

MALAYSIA : BANK NEGARA DECLARES WAR ON "CURRENCY SPECULATORS"



The ongoing saga of Bank Negara Malaysia's (BNM) battle against excess liquidity has taken a new turn. The previous issue of AMM detailed how foreign exchange reserves had surged since early 1992 as investors have sought to exploit M\$/US\$ interest rate differentials and the possibility of a M\$ capital gain. BNM has in turn been sterilising the expansionary effects of its foreign exchange intervention which has placed a cap on the credit multiplier, but has failed to deter further inflows. BNM (rightly) believes that continued high growth rates of money -- M3 expanded 24.4% yoy in October 1993 -- are undermining macroeconomic stability. It has therefore stepped up the war against "currency speculators" and introduced a series of capital controls.

In the last week of December, BNM engineered a depreciation in the M\$ against the US\$ from 2.57 to 2.70, in order to "window dress" its balance sheet. In 1992, BNM had made a "loss" of M\$9.3 billion due to losses on foreign exchange positions, sterilisation costs and a reduced M\$ value of foreign exchange reserves as a consequence of a stronger domestic currency. Anxious to minimise losses in 1993 after another year of large-scale sterilisation -- estimates for the loss are in the range of M\$10-15 billion -- BNM sought to raise the M\$ value of its foreign exchange reserves at the year end. Unfortunately for BNM, the markets had watched the same accounting trick take place a year earlier -- the M\$ fell from 2.53 against the US\$ to 2.63 before strengthening again -- and decided such a policy was not credible. Hence heavy M\$ buying which pushed the currency back up to 2.62. This market action stung BNM into action and it has subsequently unveiled six separate measures to tighten liquidity and engineer a capital outflow.

1) On January 3rd, the Statutory Reserve Ratio (SRR) was raised by 1% to 9.5%.

2) On January 11th, BNM announced that the Statutory Reserve Ratio and the Liquidity Ratio (17% of eligible liabilities) were to be extended to non-resident M\$ accounts effective from the next base period, January 16th-31st.

3) On the same day, BNM also announced that individual ceilings were to be imposed on each bank's non-trade-related, net external liability position, with effect from January 17th.

Measures 2 and 3 are estimated to have drained M\$3 billion from the money markets. They resulted in a renewed weakening of the M\$ and a scramble for M\$ paper which pushed down yields sharply.

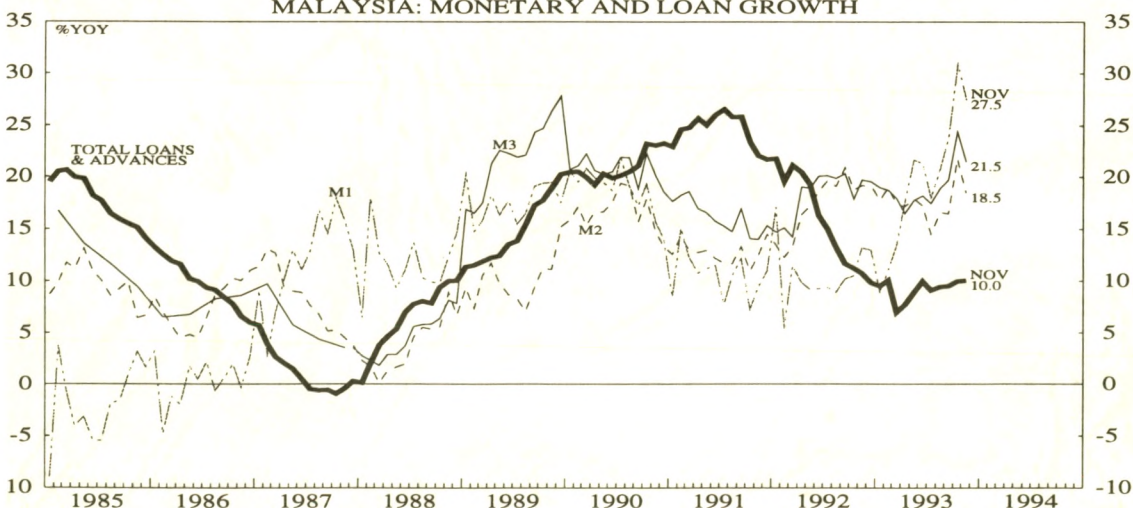
4) Two more measures were announced on January 22nd. Sales of short-term monetary instruments to non-residents were banned with effect from January 24th. Yields rose again.

5) With effect from February 2nd, non-resident M\$ deposits were required to be placed at BNM in non-interest bearing vostro accounts. Foreigners are in effect being charged 3% per annum to deposit M\$.

6) Finally, on February 22nd, non-trade-related currency swaps between local banks and offshore banks were banned.

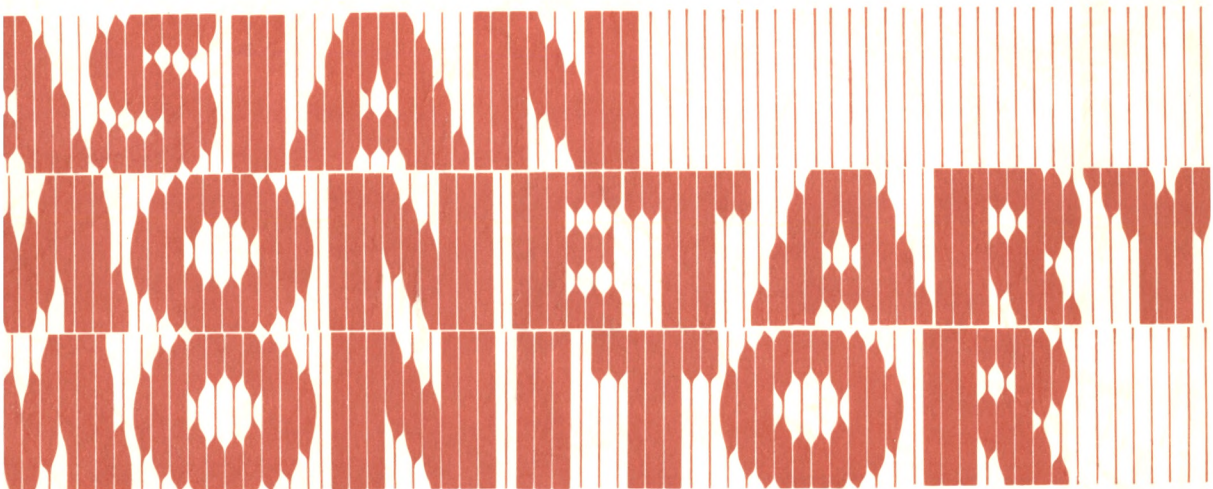
At the same time as it closed the forward foreign exchange market to non-residents, BNM pushed up the currency slightly and is believed to have struck bilateral deals with a number of institutions to allow them to liquidate their M\$ positions. The next move, however, is unclear. The fundamental case for a significantly stronger M\$ remains. Moreover a weak M\$ exacerbates inflationary pressures and is a tax on importers. Therefore pressures for a stronger currency for macroeconomic stability and political reasons are building. Over the next month or two, approximately M\$6 billion of short term paper matures, much of which is believed to be held by foreigners. If vostro accounts jump from the current level of M\$5-6 billion, then BNM will know that 1) a sizeable portion of the inflow has not left the system and 2) it is not looking to do so. This could precipitate BNM to introduce another series of measures -- higher negative interest rates, for example. However, longer term BNM must choose between waging war on speculators and macroeconomic stability. As a result, the M\$ should be nearer 2.60 than 2.70 by year end.

MALAYSIA: MONETARY AND LOAN GROWTH



18 MAR 94





CONTENTS

	Page
JAPAN	
A Deflationary Recovery by John Greenwood	1
TAIWAN	
Monetary Policy, Capital Controls and Financial Liberalisation by Philip Wyatt	9
TURKEY	
Causes and Consequences of the Financial Crisis by Tim Lee	23
ECONOMIC CAPSULES	
Indonesia : OECD Growth to Boost Exports	JWL / PTW 32
Malaysia : Monetary Tightening on Horizon	JWL / PTW 34
Philippines : Fragile Recovery Justifies Currency Depreciation	JWL / PTW 36
Singapore : Currency Appreciation Will Lift Interest Rates	JWL / PTW 38
Thailand : Monetary Tightening to Follow Rises in US Rates	JWL / PTW 40





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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price US\$300 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to the Editor, Asian Monetary Monitor Ltd., GPO Box 12964, Hong Kong.

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ASIAN MONETARY MONITOR

March-April 1994

Vol. 18 No.2

JAPAN A DEFLATIONARY RECOVERY

Introduction

In the past Japanese recoveries have typically been export-led. With the yen remaining firm in the Yen 100-110 per US\$ range, and US-Japan trade politics tending to hold it there, it looks less and less likely that Japan can achieve an export-led recovery from the current protracted recession. The shape of the next recovery will therefore be much more like an orthodox OECD, rich-country style recovery led by components of domestic demand such as consumption, housing and government expenditures. As the recovery broadens Japan's trade and current accounts are likely to deteriorate, which in turn means that balance of payments-induced improvements in liquidity are far less likely to materialise than in previous upswings when the currency was weaker and the balance of payments was stronger.

An earlier AMM article on Japan ("Preconditions for an Economic Recovery", July-August 1992) argued that without a substantial acceleration in money growth from 2% year-on-year growth of M2+CDs no recovery would be possible until real purchasing power started expanding sufficiently to create an increase in real money balances. This in turn required inflation to be falling by 4-5% p.a. assuming a real economic growth potential of 4.3% p.a., and a trend decline in income velocity of 2.5% p.a.:

$$\dot{P} = \dot{M} + \dot{V} - \dot{Y} = 2 + (-2.5) - 4.3 = -4.8$$

Even if the growth potential is assumed to be as low as 3% and it is assumed that henceforth velocity will only decline at half its previous rate, the implied price decline necessary to produce real growth of money balances is 2.25% p.a.:

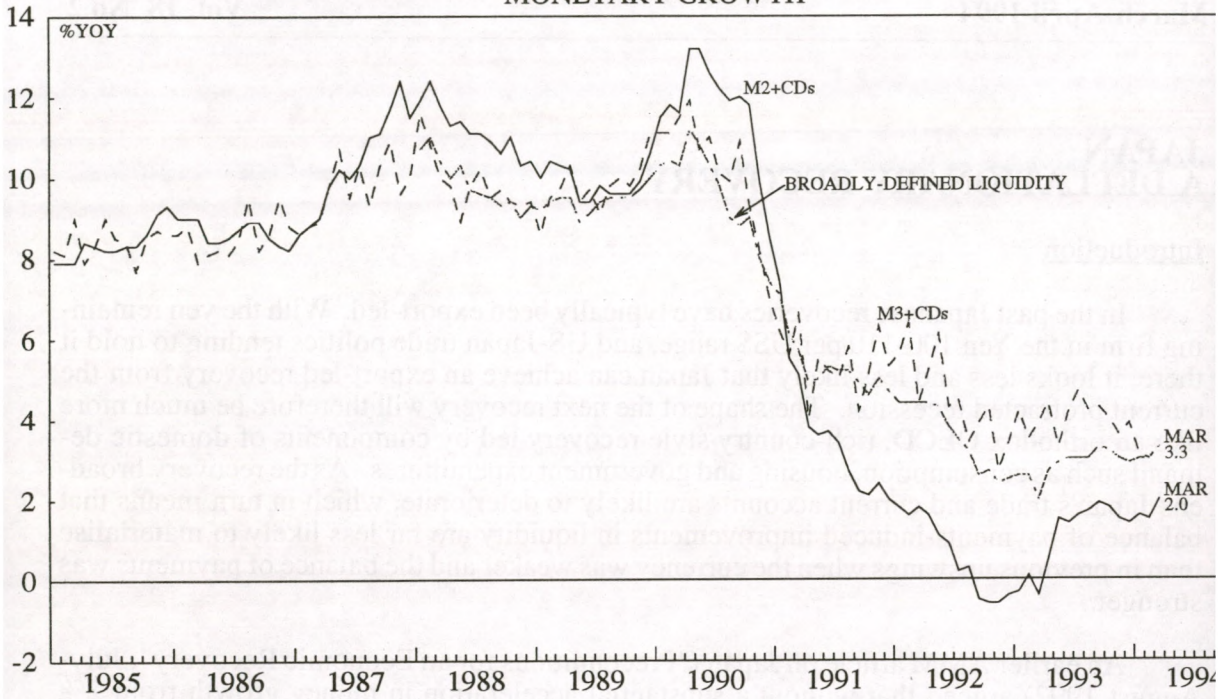
$$\dot{P} = \dot{M} + \dot{V} - \dot{Y} = 2 + (-1.25) - 3 = -2.25$$

This article argues that since money growth (M2+CDs) has remained consistently below 2% year-on-year for nearly three years, and in addition M3+CDs has averaged below 4% for two years, economic conditions in Japan are such that the price level, when properly measured, is probably approaching the rates of decline required by the quantity theory equations above. In other words, Japan could be on the threshold of a recovery albeit with falling prices, i.e., a deflationary recovery.

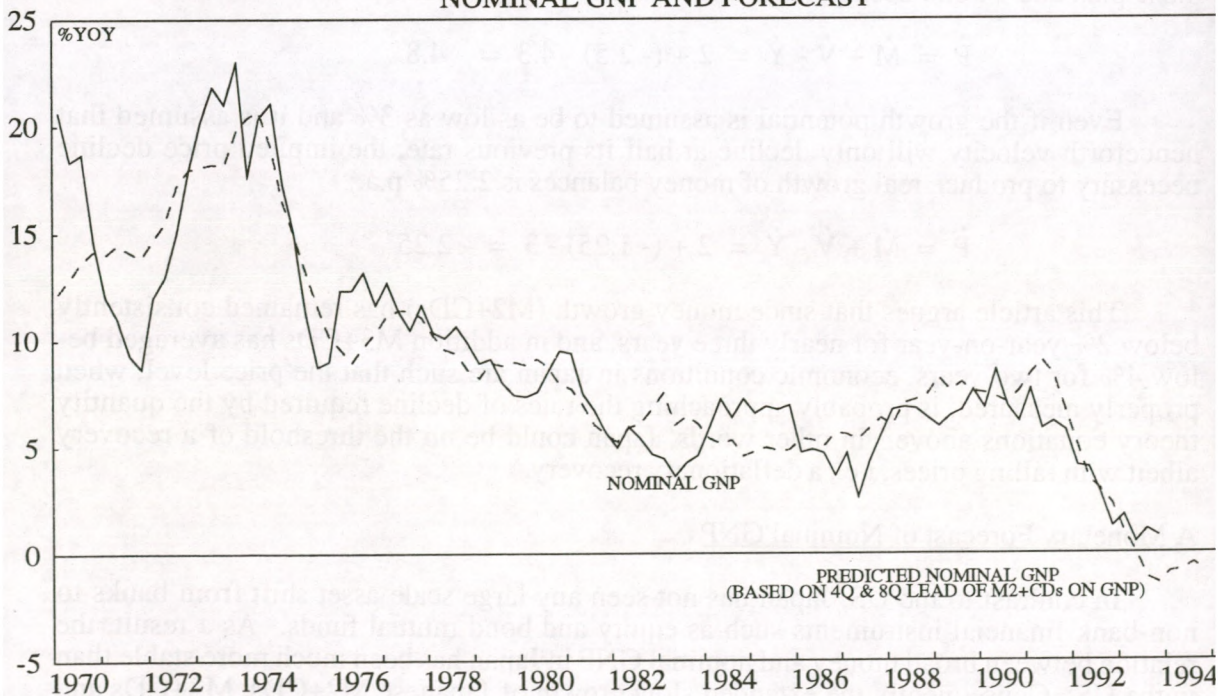
A Monetary Forecast of Nominal GNP

In contrast to the US, Japan has not seen any large scale asset shift from banks to non-bank financial instruments such as equity and bond mutual funds. As a result, the relation between broad money and nominal GNP in Japan has been much more stable than in the US. Consequently the extended slow growth of Japanese M2+CDs, M3+CDs and broadly defined liquidity (all shown in Chart 1) in 1992-93 has translated fairly directly into

JAPAN: CHART 1
MONETARY GROWTH



JAPAN: CHART 2
NOMINAL GNP AND FORECAST



very slow growth rates of spending in nominal terms. Using the relation between M2+CDs and nominal GNP over the past 20 years and a four-quarter and eight-quarter lag generates a forecast for negative nominal GNP in 1994 of about -1.5% (Chart 2). From the discussion of the quantity equation above, positive growth of Japanese real GNP cannot be achieved until the GNP deflator or a similar broad index of inflation is actually falling by 2-5% p.a. We shall therefore discuss the split of nominal GNP between real growth and inflation within this framework.

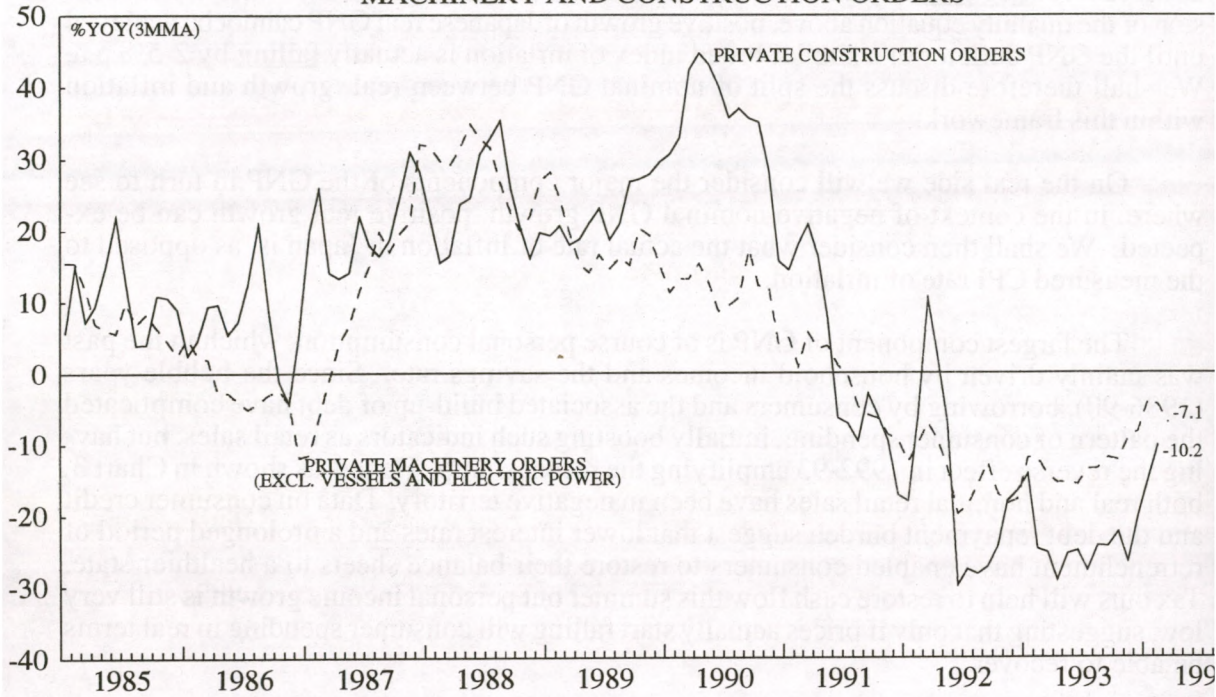
On the real side we will consider the major components of the GNP in turn to see where, in the context of negative nominal GNP growth, positive real growth can be expected. We shall then consider what the actual rate of inflation in Japan is, as opposed to the measured CPI rate of inflation.

The largest component of GNP is of course personal consumption, which in the past was mainly driven by household incomes and the savings rate. Since the bubble years (1986-90), borrowing by consumers and the associated build-up of debt have complicated the pattern of consumer spending, initially boosting such indicators as retail sales, but having the reverse effect in 1992-93 amplifying the recent slump. Hence, as shown in Chart 3, both real and nominal retail sales have been in negative territory. Data on consumer credit and the debt repayment burden suggest that lower interest rates and a prolonged period of retrenchment have enabled consumers to restore their balance sheets to a healthier state. Tax cuts will help to restore cash flow this summer but personal income growth is still very low, suggesting that only if prices actually start falling will consumer spending in real terms be able to recover.

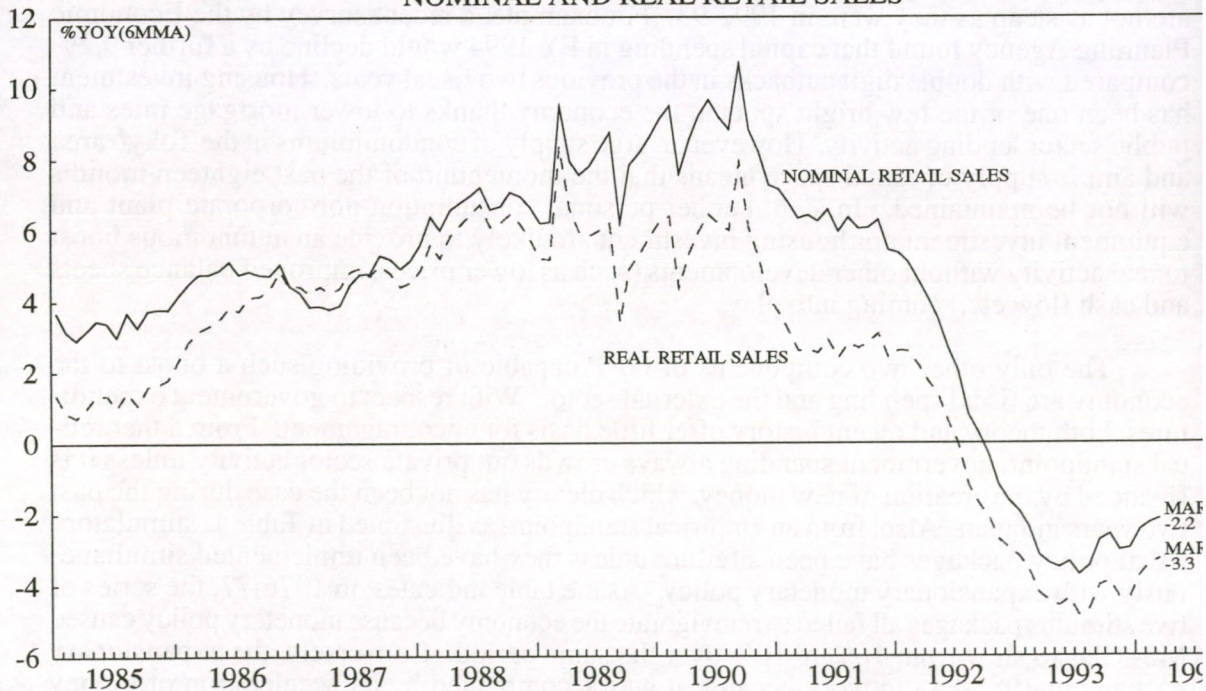
In the corporate sector balance sheet adjustment has been going on for three years now, but with nominal sales falling, excess capacity and excess inventories remain a persistent problem. Therefore, indicators of capital expenditure (Chart 4) and surveys of corporate capex intentions point to continued declines in spending, even though those declines are not as steep as they were in 1992-93. For example, a recent survey by the Economic Planning Agency found that capital spending in FY 1994 would decline by a further 9.2% compared with double digit cutbacks in the previous two fiscal years. Housing investment has been one of the few bright spots in the economy thanks to lower mortgage rates and public sector lending activity. However, a large supply of condominiums in the Tokyo area and ample supply of rental space means that the momentum of the past eighteen months will not be maintained. In sum, neither personal consumption nor corporate plant and equipment investment nor housing investment are likely to provide an autonomous boost to real activity without other developments (such as lower prices, improved balance sheets and cash flow etc.) coming into play.

The only other two components of GNP capable of providing such a boost to the economy are fiscal spending and the external sector. With respect to government expenditures, both theory and recent history offer little basis for encouragement. From a theoretical standpoint, government spending always crowds out private sector activity unless it is financed by the creation of new money, which clearly has not been the case during the past two years in Japan. Also, from an empirical standpoint, as illustrated in Table 1, stimulatory fiscal policy packages have been a failure unless they have been implemented simultaneously with expansionary monetary policy. As the table indicates, in 1976-77, the series of five stimulus packages all failed to reinvigorate the economy because monetary policy caused M2+CDs to slow from 16% to 10% over the same period. Conversely, the expansionary package in 1987-88 did work because it was accompanied by an acceleration of money growth from 8% to 12%. The most recent series of fiscal stimulus packages have laboured

JAPAN: CHART 3
MACHINERY AND CONSTRUCTION ORDERS



JAPAN: CHART 4
NOMINAL AND REAL RETAIL SALES



under the same constraint as the 1976-77 series, namely a restrictive monetary policy. It follows, therefore, that unless the Bank of Japan can be induced to act more vigorously to achieve a monetary and credit expansion, there is no basis for pinning much hope on fiscal policy as a mechanism for generating a Japanese economic recovery.

In most of Japan's postwar recoveries, exports have led the way. This has resulted in a positive contribution to GNP from a growing trade surplus. Taking the two recoveries in the past 20 years, i.e., in 1975 and 1981, trade deficits shifted to surpluses in both cases. First, in 1974 the balance of trade recovered sharply from a deficit to near balance, and then gradually built up to a US\$2 bn surplus per month by 1978. Again, after the second oil crisis of 1979-80, export growth picked up so that the trade balance shifted from monthly deficits of about \$2 billion to peak at a surplus of around \$8 billion per month by 1986. The last four years (1990-94) have seen another build-up in the trade surplus, but this time due mainly to a repeated series of J-curve phenomena (i.e., the trade balance initially moving in the opposite direction to its ultimate equilibrium level). As shown in Chart 5 the volumes of exports and imports have been moving adversely since early 1993, with import volume growth exceeding export volume growth by 12% on a six-month moving average basis. Since this difference in trade volume is traditionally a good predictor of the direction of the trade balance in value terms, the implication is that once the J-curve effects are over, Japan's trade balance will narrow quite decisively.

Looking ahead, since the yen is still overvalued on a purchasing power parity basis, it seems likely that the balance of trade and the current account will deteriorate from their record surplus levels as the Japanese economy recovers. The incentives to Japanese companies to relocate plant to cheaper costs areas either in Asia or elsewhere are still overwhelming, and import volumes seem likely to continue to rise as cheaper foreign manufactured goods are substituted for domestic products, or as Japanese producers increasingly buy components from overseas. Conversely, the strong yen is undermining Japan's export competitiveness as evidenced by the 18.3% year-on-year decline in vehicle exports in FY 1993. In March 1994 vehicle exports were down 24.5% year-on-year. As a result, the contribution of the balance of goods and services to the GNP or GDP will almost certainly be negative during 1994, slowing or detracting from any recovery of the overall economy.

If all these components of the real GNP cannot generate a recovery independently -- which of course is theoretically implausible -- then the only alternative way of achieving a real recovery in 1994 will be through price declines sufficient to convert the negative nominal GNP into positive real output plus a substantial fall in the price level. Is this remotely feasible? In our view the answer is that such a combination is definitely possible, and may even start to happen during the next few months. To understand such an outcome requires recognising two points.

First, historically there have been times when economies have experienced positive real growth combined with falling prices. In the period 1870-1890, generally known as the great depression (because prices were falling), real incomes in Britain and in the US grew at rates of 2-3% p.a. Another example of a country experiencing falling prices with positive real growth is the example of Japan in the 1920s when prices fell by an average of -3.4% p.a., while national income in real terms grew at +2.1% p.a. Although inflation rather than deflation has been the rule in the post-1945 world, there is no theoretical reason why the same nineteenth century or pre-war experiences should not be repeated.

**JAPAN: CHART 5
TRADE SURPLUS AND TRADE VOLUME**

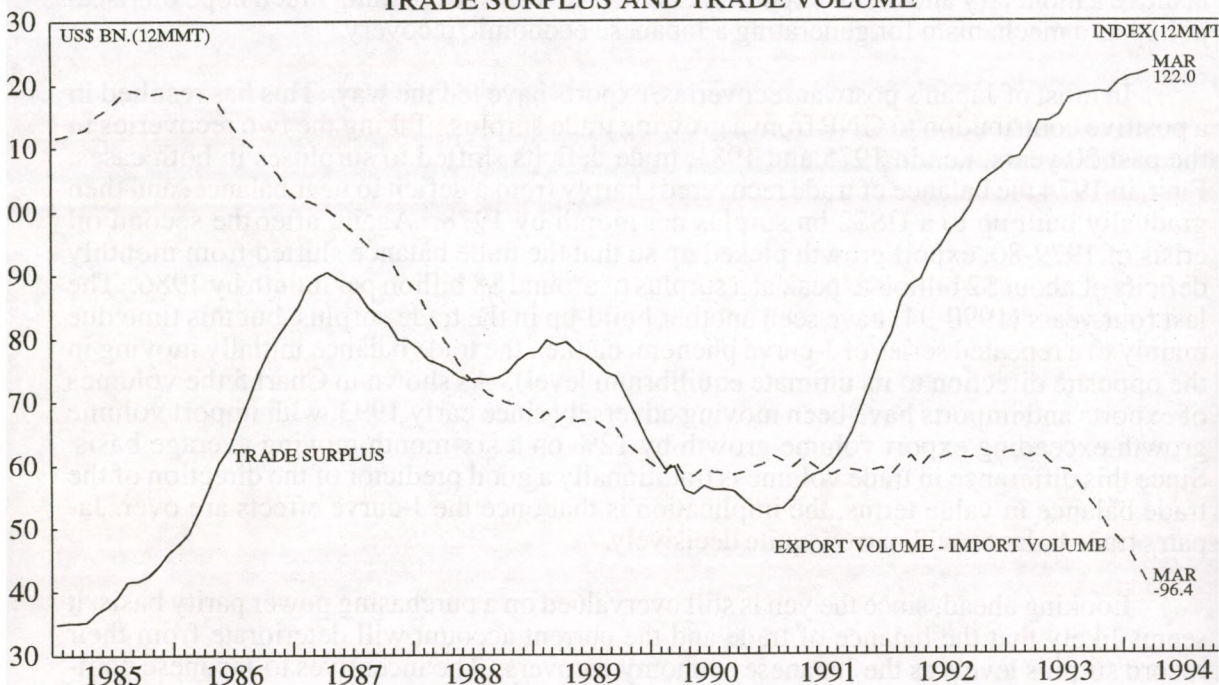
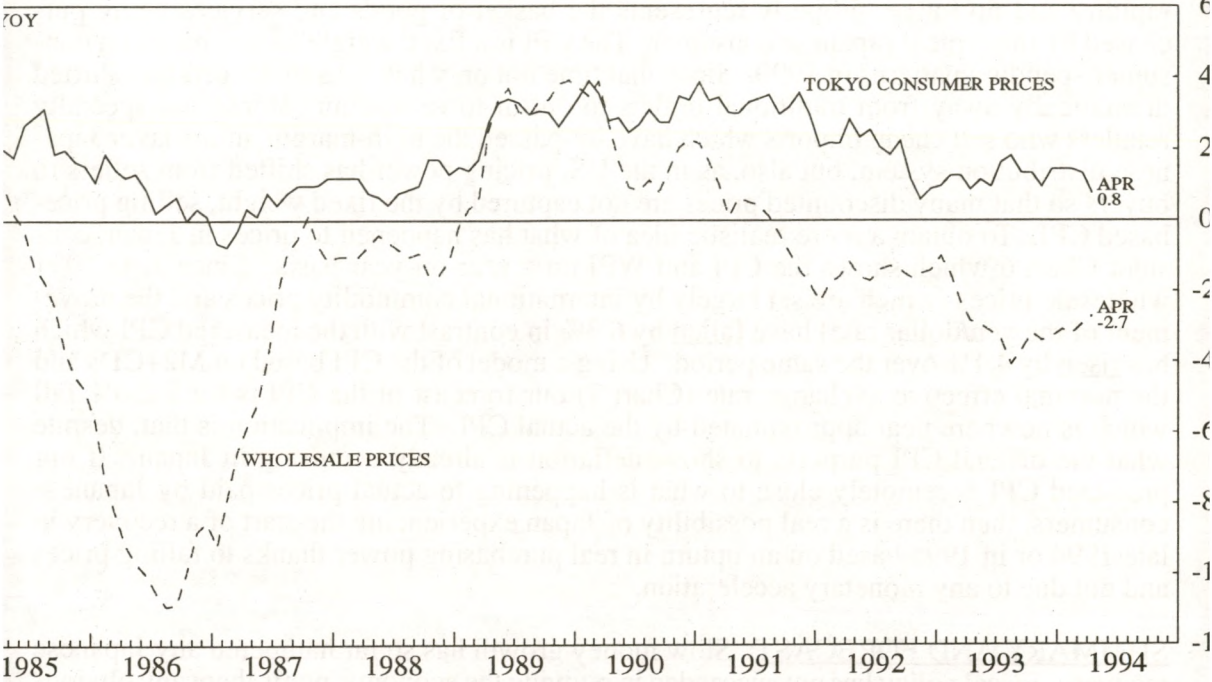


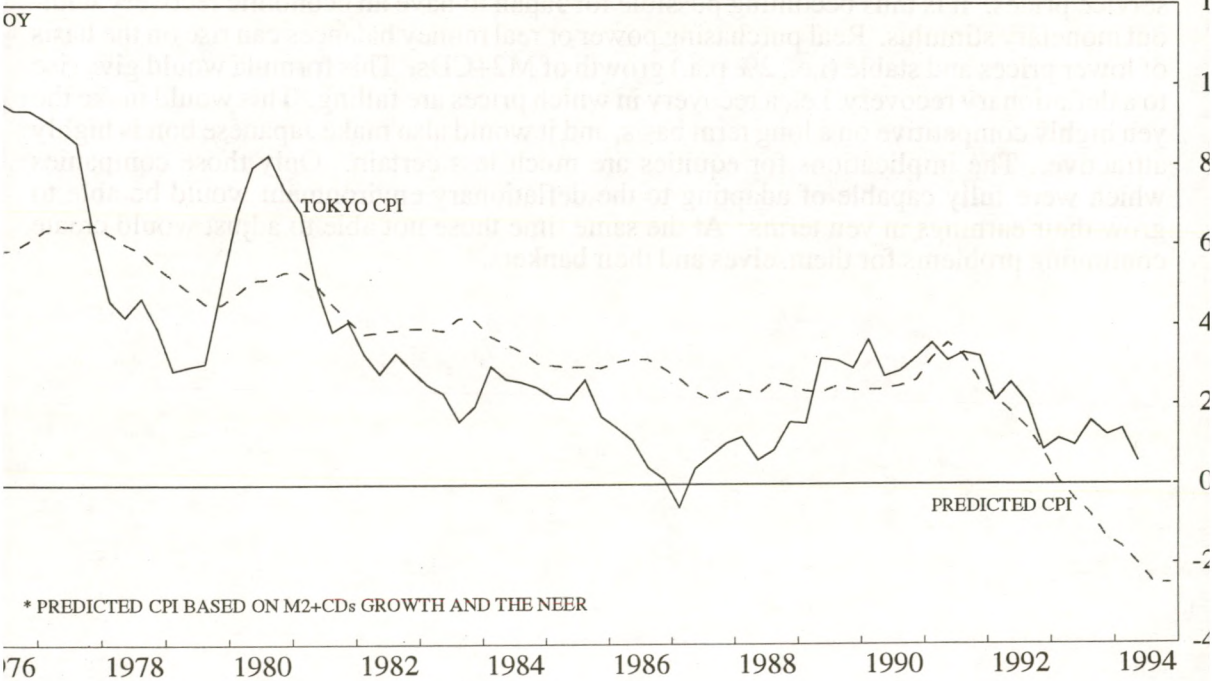
TABLE 1: MONETARY POLICY VERSUS FISCAL POLICY IN JAPAN

FISCAL POLICY	MONETARY POLICY	OUTCOME
EPISODE 1, 1976-77 5 Fiscal Stimulus Packages (Sept 76-Sept 77) EXPANSIONARY	M2+CDs growth slows (16% to 10%) CONTRACTIONARY	IIP slows (20% to -2%); real GNP slows (8% to 4%) ECONOMIC SLOWDOWN
EPISODE 2, 1987-88 FY87 Supplementary Budget (Yen 2.1 trn) EXPANSIONARY	M2+CDs growth rises (8% to 12%) EXPANSIONARY	IIP accelerates (0% to 10%); GNP upturn ECONOMIC UPSWING
EPISODE 3, 1992-94 4 Fiscal Stimulus Packages 1992-94 EXPANSIONARY	M2+CDs growth slows (10% to 0%) and stays low CONTRACTIONARY	IIP falls by 4% p.a. Real GNP records absolute declines RECESSION PERSISTS

JAPAN: CHART 6
INFLATION



JAPAN: CHART 7
ACTUAL AND PREDICTED INFLATION



Second, the CPI currently used in Japan has become obsolete with extraordinary rapidity and no longer properly represents the basket of goods and services being purchased by the typical Japanese consumer. The CPI is a fixed weight basket based on consumer spending patterns in 1990. Since that time not only has consumer spending shifted dramatically away from traditional outlets to out-of-town discount stores and specialty retailers who sell cheap imports which have by-passed the high-margin, multi-layer Japanese distribution system, but also, as in the US, pricing power has shifted from sellers to buyers so that many discounted prices are not captured by the fixed weight, selling price-based CPI. To obtain a more realistic idea of what has happened to prices in Japan, consider Chart 6 which shows the CPI and WPI on a year-on-year basis. Since June 1991 wholesale prices (which are set largely by international commodity prices and the movement of the yen/dollar rate) have fallen by 6.3% in contrast with the measured CPI which has risen by 4.1% over the same period. Using a model of the CPI based on M2+CDs and the nominal effective exchange rate (Chart 7) our forecast of the CPI is for a 2-3% fall which is nowhere near approximated by the actual CPI. The implication is that, despite what the official CPI purports to show, deflation is already occurring in Japan. If our predicted CPI is remotely close to what is happening to actual prices paid by Japanese consumers, then there is a real possibility of Japan experiencing the start of a recovery in late 1994 or in 1995 based on an upturn in real purchasing power thanks to falling prices and not due to any monetary acceleration.

SUMMARY AND FORECAST: Slow money growth has so far hampered any Japanese recovery. Fiscal policy has not succeeded in reviving the economy, nor is there any obvious prospect of an independent stimulus coming from other components of GNP. However, since the monetary squeeze has been in place so long, prices -- in the sense of actual selling prices as opposed to the officially measured CPI -- are finally beginning to reflect the very real deflation which has percolated through from asset prices and output to goods and service prices. It is thus becoming possible for Japan to have an economic recovery without monetary stimulus. Real purchasing power or real money balances can rise on the basis of lower prices and stable (i.e., 2% p.a.) growth of M2+CDs. This formula would give rise to a deflationary recovery, i.e., a recovery in which prices are falling. This would make the yen highly competitive on a long term basis, and it would also make Japanese bonds highly attractive. The implications for equities are much less certain. Only those companies which were fully capable of adapting to the deflationary environment would be able to grow their earnings in yen terms. At the same time those not able to adjust would create continuing problems for themselves and their bankers.

TAIWAN MONETARY POLICY, CAPITAL CONTROLS AND FINANCIAL LIBERALISATION

Introduction: The Monetary cycle across East Asia: where Taiwan stands

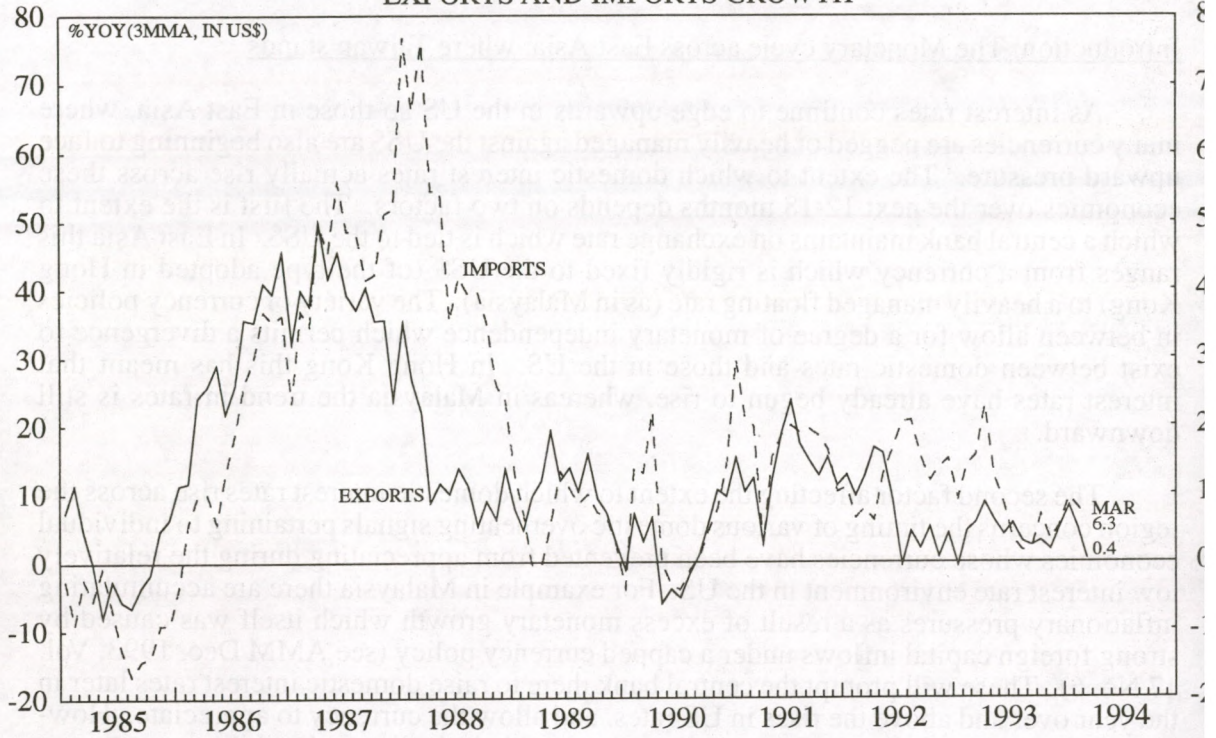
As interest rates continue to edge upwards in the US so those in East Asia, where many currencies are pegged or heavily managed against the US\$ are also beginning to face upward pressure. The extent to which domestic interest rates actually rise across these economies over the next 12-18 months depends on two factors. The first is the extent to which a central bank maintains an exchange rate which is tied to the US\$. In East Asia this ranges from a currency which is rigidly fixed to the US\$ (of the type adopted in Hong Kong) to a heavily managed floating rate (as in Malaysia). The variety of currency policies in between allow for a degree of monetary independence which permits a divergence to exist between domestic rates and those in the US. In Hong Kong this has meant that interest rates have already begun to rise, whereas in Malaysia the trend in rates is still downward.

The second factor affecting the extent to which domestic interest rates rise across the region concerns the timing of various domestic overheating signals pertaining to individual economies whose currencies have been prevented from appreciating during the relatively low interest rate environment in the US. For example in Malaysia there are accumulating inflationary pressures as a result of excess monetary growth which itself was caused by strong foreign capital inflows under a capped currency policy (see AMM Dec. 1993, Vol. 17 No. 6). These will prompt the central bank there to raise domestic interest rates later in the year over and above the rises in US rates, and allow the currency to appreciate. However in the meantime, interest rates have yet to stop their decline and stabilise.

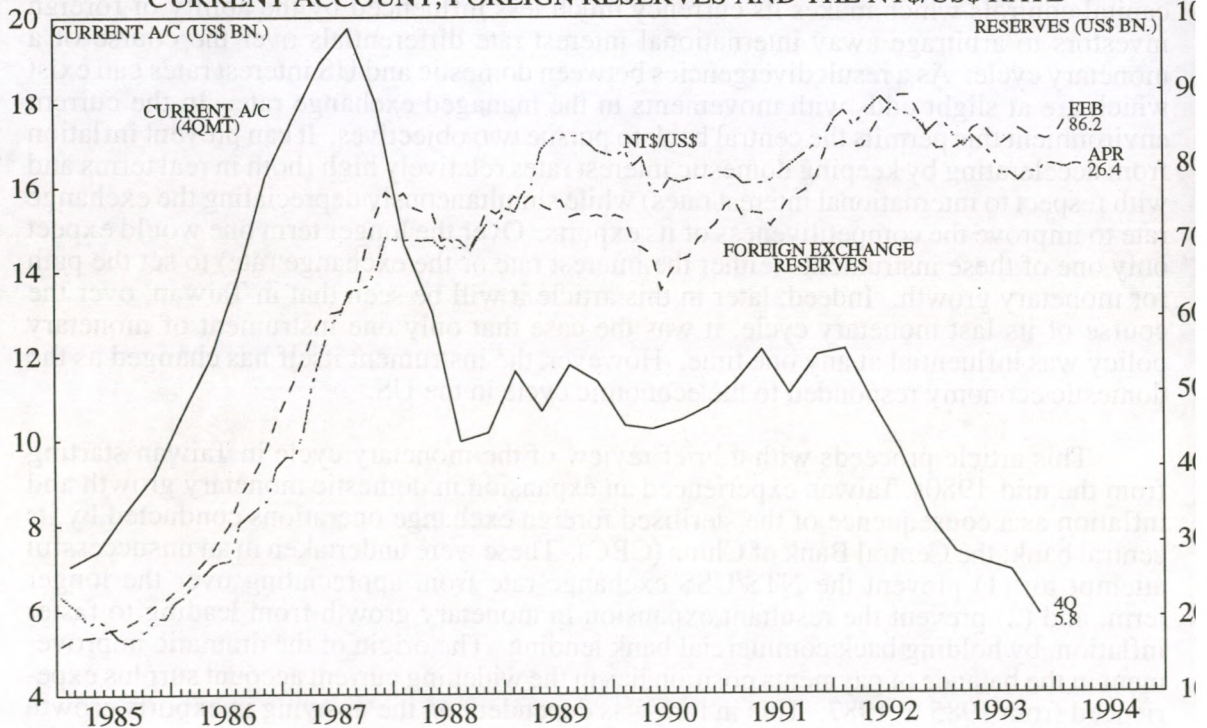
Taiwan differs from many of the ASEAN economies in that it has retained substantial capital controls which makes its currency much less influenced by the ability of foreign investors to arbitrage away international interest rate differentials over the course of a monetary cycle. As a result divergencies between domestic and US interest rates can exist which are at slight odds with movements in the managed exchange rate. In the current environment this permits the central bank to pursue two objectives. It can prevent inflation from accelerating by keeping domestic interest rates relatively high (both in real terms and with respect to international interest rates) while simultaneously depreciating the exchange rate to improve the competitiveness of its exports. Over the longer term one would expect only one of these instruments (either the interest rate or the exchange rate) to set the path for monetary growth. Indeed, later in this article it will be seen that in Taiwan, over the course of its last monetary cycle, it was the case that only one instrument of monetary policy was influential at any one time. However, the instrument itself has changed as the domestic economy responded to the economic cycle in the US.

This article proceeds with a brief review of the monetary cycle in Taiwan starting from the mid-1980s. Taiwan experienced an expansion in domestic monetary growth and inflation as a consequence of the sterilised foreign exchange operations conducted by its central bank: the Central Bank of China (CBC). These were undertaken in an unsuccessful attempt to: (1) prevent the NT\$/US\$ exchange rate from appreciating over the longer term, and (2) prevent the resultant expansion in monetary growth from leading to faster inflation, by holding back commercial bank lending. The origin of the dramatic improvement in the balance of payments position lies in the widening current account surplus experienced from 1985 to 1987. This in turn was dependent on the upswing in exports growth which was caused by a depreciated currency together with a global upturn in industrial

TAIWAN: CHART 1
EXPORTS AND IMPORTS GROWTH



TAIWAN: CHART 2
CURRENT ACCOUNT, FOREIGN RESERVES AND THE NT\$/US\$ RATE



production during that time (Charts 1 and 2).

The sterilised foreign exchange intervention experience of Taiwan contrasts with those of Malaysia and Indonesia over 1993. The source of the rise in foreign exchange reserves in these latter countries over 1993 is the strong net inflow of capital attracted to the East Asian region against the background of relatively low US interest rates over the last two years. The much more closed capital account in Taiwan has shielded the NT\$/US\$ from the upward pressure that it would have experienced in the face of strong capital flows over the past two years. As a result, the CBC has not had to conduct expansionary foreign exchange operations to prevent the nominal exchange rate from appreciating and which would have brought down domestic interest rates in the process. Taiwan has therefore not benefitted from the upswing in economic growth that would have resulted from the implied monetary expansion, as is the case in Malaysia, Indonesia and Thailand. However, as a result, Taiwan does not face the near term prospect of an upturn in inflation. This means that the CBC will not need to raise the level of domestic interest rates in the months ahead, neither will it necessarily inherit higher interest rates as a result of the upswing in US rates given the CBCs continued desire to maintain a stable or pegged exchange rate. On the contrary, the CBC may be under greater political pressure during 1994 to stimulate the economy either by reducing interest rates or by depreciating the exchange rate or both.

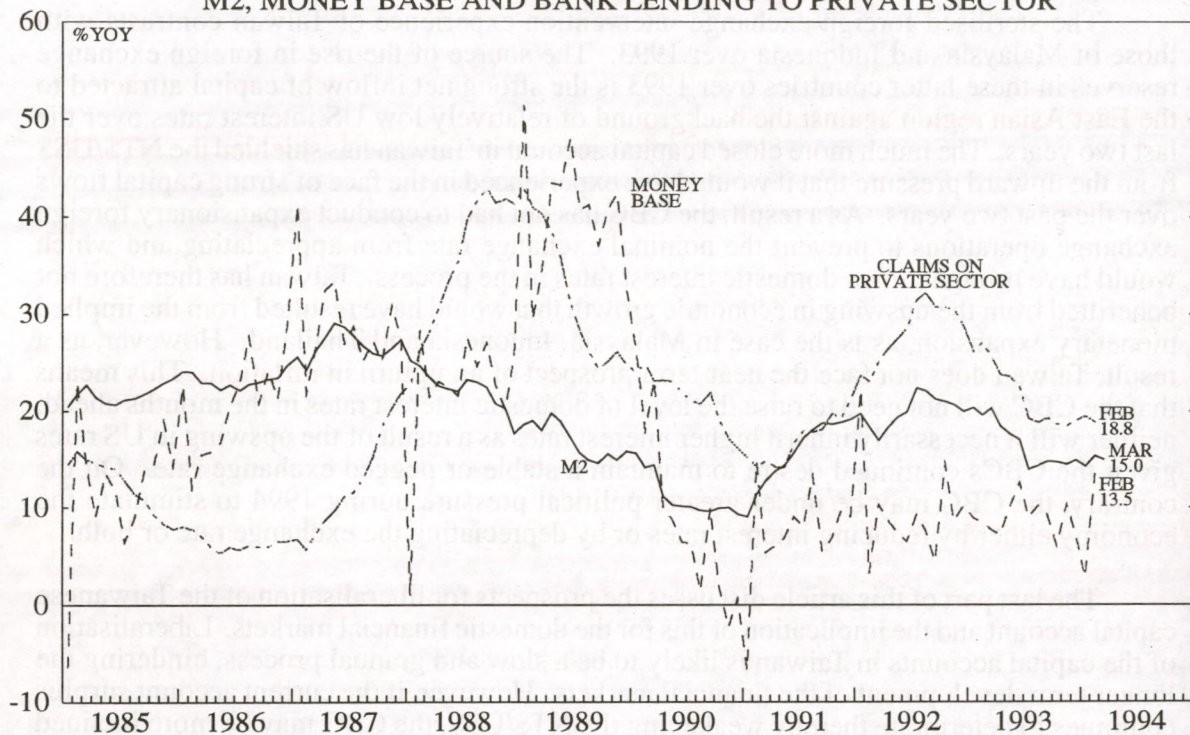
The last part of this article discusses the prospects for liberalisation of the Taiwanese capital account and the implication of this for the domestic financial markets. Liberalisation of the capital accounts in Taiwan is likely to be a slow and gradual process, hindering the longer term development of the financial markets. However, if the current account surplus continues to deteriorate thereby weakening the NT\$/US\$, the CBC may be more inclined to relax some of the existing restrictions on foreign capital flows sooner than it would otherwise have done, in an attempt to attract foreign capital. In this event the depreciation in the NT\$/US\$ rate could be kept in check.

A Brief Review of Monetary Policy in Taiwan since 1985

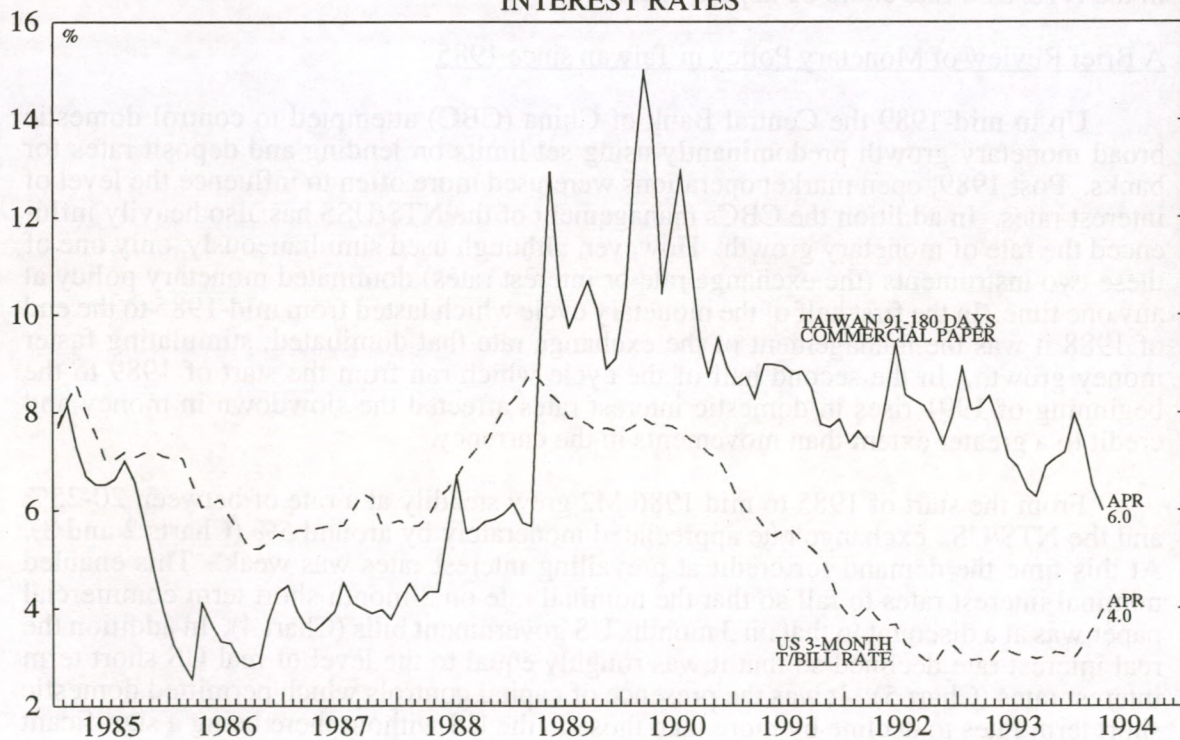
Up to mid-1989 the Central Bank of China (CBC) attempted to control domestic broad monetary growth predominantly using set limits on lending and deposit rates for banks. Post 1989, open market operations were used more often to influence the level of interest rates. In addition the CBCs management of the NT\$/US\$ has also heavily influenced the rate of monetary growth. However, although used simultaneously, only one of these two instruments (the exchange rate or interest rates) dominated monetary policy at any one time. In the first half of the monetary cycle which lasted from mid-1985 to the end of 1988 it was the management of the exchange rate that dominated; stimulating faster money growth. In the second half of the cycle which ran from the start of 1989 to the beginning of 1991 rises in domestic interest rates affected the slowdown in money and credit to a greater extent than movements in the currency.

From the start of 1985 to mid 1986 M2 grew steadily at a rate of between 20-25% and the NT\$/US\$ exchange rate appreciated moderately by around 5% (Charts 2 and 3). At this time the demand for credit at prevailing interest rates was weak. This enabled nominal interest rates to fall so that the nominal rate on 3 month short term commercial paper was at a discount to that on 3 months US government bills (Chart 4). In addition the real interest rate declined so that it was roughly equal to the level of real US short term interest rates (Chart 5). It was the presence of capital controls which permitted domestic short term rates to decline by more than those in the US without there being a significant weakening in the NT\$/US\$. Indeed during 1986 and into 1987, following the expansion in

TAIWAN: CHART 3
M2, MONEY BASE AND BANK LENDING TO PRIVATE SECTOR



TAIWAN: CHART 4
INTEREST RATES



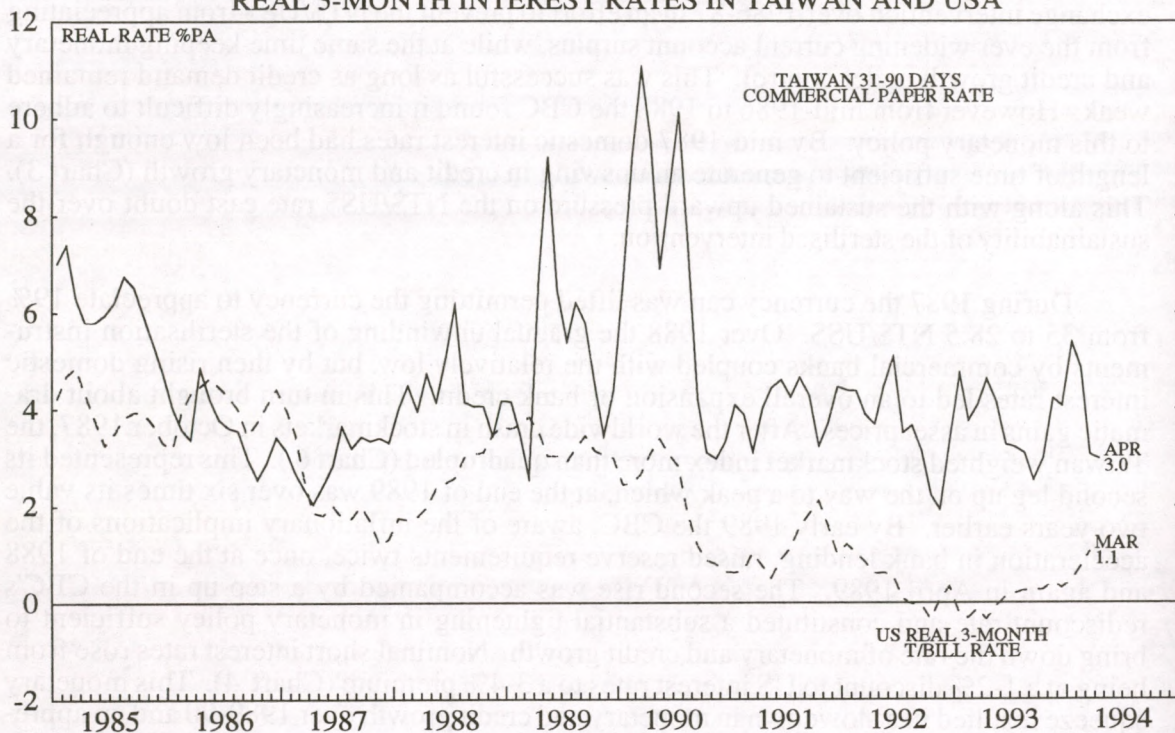
OECD industrial production, and subsequent widening in the current account surplus, the NT\$/US\$ experienced mounting upward pressure. The CBC conducted sterilised foreign exchange intervention over 1986-87 in an effort to prevent the NT\$/US\$ from appreciating from the ever widening current account surplus, while at the same time keeping monetary and credit growth under control. This was successful as long as credit demand remained weak. However from mid-1986 to 1988 the CBC found it increasingly difficult to adhere to this monetary policy. By mid-1987 domestic interest rates had been low enough for a length of time sufficient to generate an upswing in credit and monetary growth (Chart 3). This along with the sustained upward pressure on the NT\$/US\$ rate cast doubt over the sustainability of the sterilised intervention.

During 1987 the currency cap was lifted permitting the currency to appreciate 19% from 35 to 28.5 NT\$/US\$. Over 1988 the gradual unwinding of the sterilisation instruments by commercial banks coupled with the relatively low, but by then rising domestic interest rates led to an overall expansion of bank credit. This in turn brought about dramatic gains in asset prices. After the worldwide crash in stockmarkets in October 1987, the Taiwan weighted stockmarket index more than quadrupled (Chart 6). This represented its second leg up on the way to a peak which, at the end of 1989 was over six times its value two years earlier. By early 1989 the CBC, aware of the inflationary implications of the acceleration in bank lending, raised reserve requirements twice, once at the end of 1988 and again in April 1989. The second rise was accompanied by a step up in the CBC's rediscount rate and constituted a substantial tightening in monetary policy sufficient to bring down the rate of monetary and credit growth. Nominal short interest rates rose from being at a 1-2% discount to US interest rates to a 3-4% premium (Chart 4). This monetary squeeze resulted in a slowdown in monetary and credit growth over 1989-90 and an appreciation in the exchange rate by another 7-8% (reaching around 25.6 NT\$/US\$ in mid-1989). The stockmarket crashed in the first few months of 1990. Inflation, which by 1989 had begun to accelerate did not show signs of slowing until early 1991 (Chart 7).

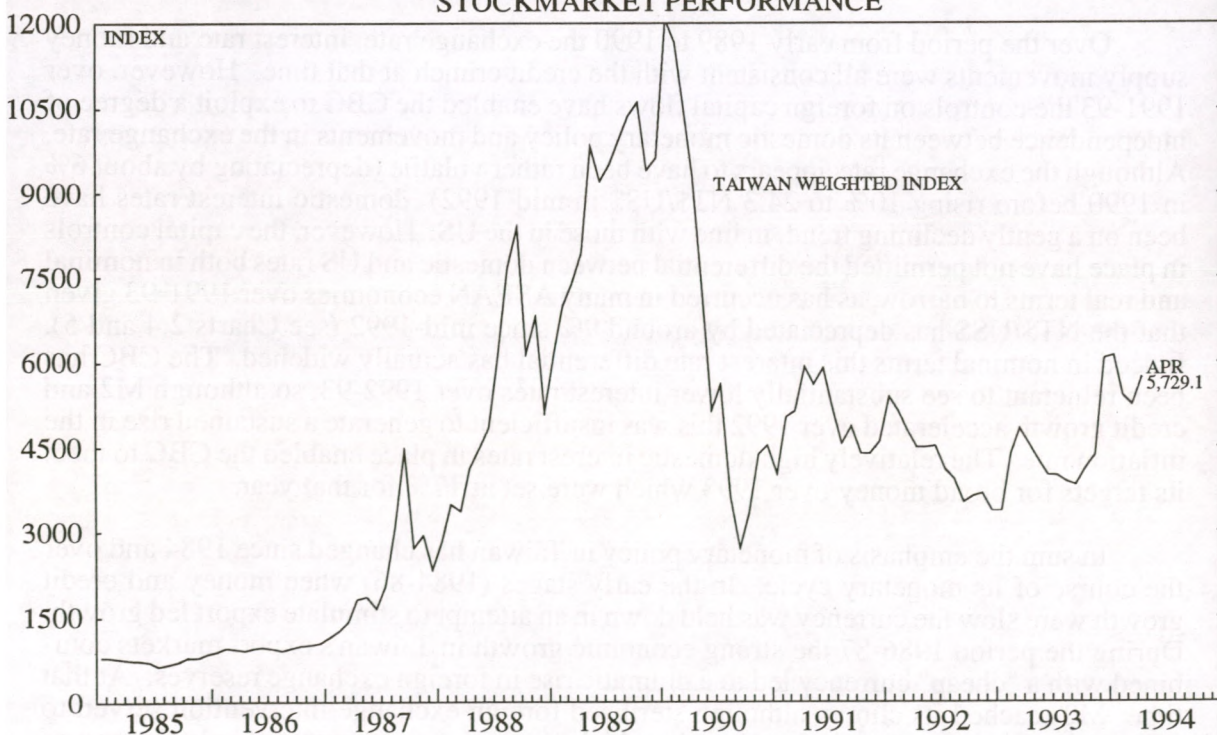
Over the period from early 1989 to 1990 the exchange rate, interest rate and money supply movements were all consistent with the credit crunch at that time. However, over 1991-93 the controls on foreign capital flows have enabled the CBC to exploit a degree of independence between its domestic monetary policy and movements in the exchange rate. Although the exchange rate appears to have been rather volatile (depreciating by about 6% in 1990 before rising 10% to 24.3 NT\$/US\$ in mid-1992) domestic interest rates have been on a gently declining trend, in line with those in the US. However, the capital controls in place have not permitted the differential between domestic and US rates both in nominal and real terms to narrow, as has occurred in many ASEAN economies over 1991-93 given that the NT\$/US\$ has depreciated by around 9% since mid-1992 (see Charts 2,4 and 5). Indeed in nominal terms this interest rate differential has actually widened. The CBC has been reluctant to see substantially lower interest rates over 1992-93, so although M2 and credit growth accelerated over 1992 this was insufficient to generate a sustained rise in the inflation rate. The relatively high domestic interest rates in place enabled the CBC to meet its targets for broad money over 1993 which were set at 17% for that year.

In sum the emphasis of monetary policy in Taiwan has changed since 1984 and over the course of its monetary cycle. In the early stages (1984-86) when money and credit growth were slow the currency was held down in an attempt to stimulate export led growth. During the period 1986-87 the strong economic growth in Taiwan's export markets combined with a "cheap" currency led to a dramatic rise in foreign exchange reserves. At that time M2 reached its climax although sterilised foreign exchange intervention served to delay the eventual upturn in bank credit which reached a maximum towards the end of

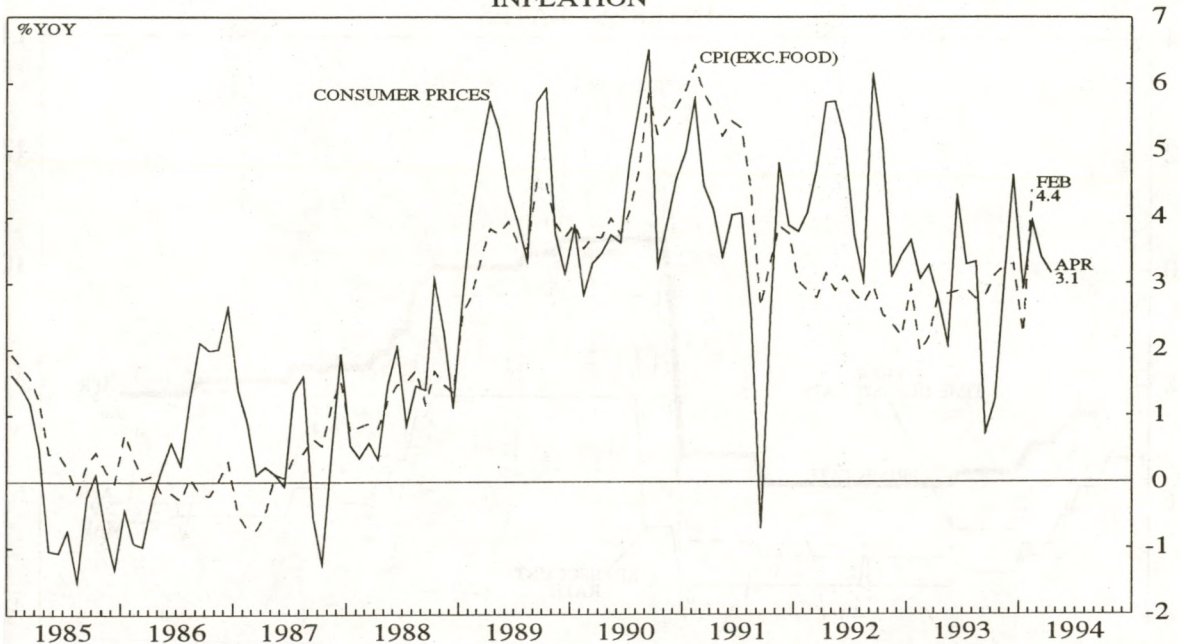
TAIWAN: CHART 5
REAL 3-MONTH INTEREST RATES IN TAIWAN AND USA



TAIWAN: CHART 6
STOCKMARKET PERFORMANCE



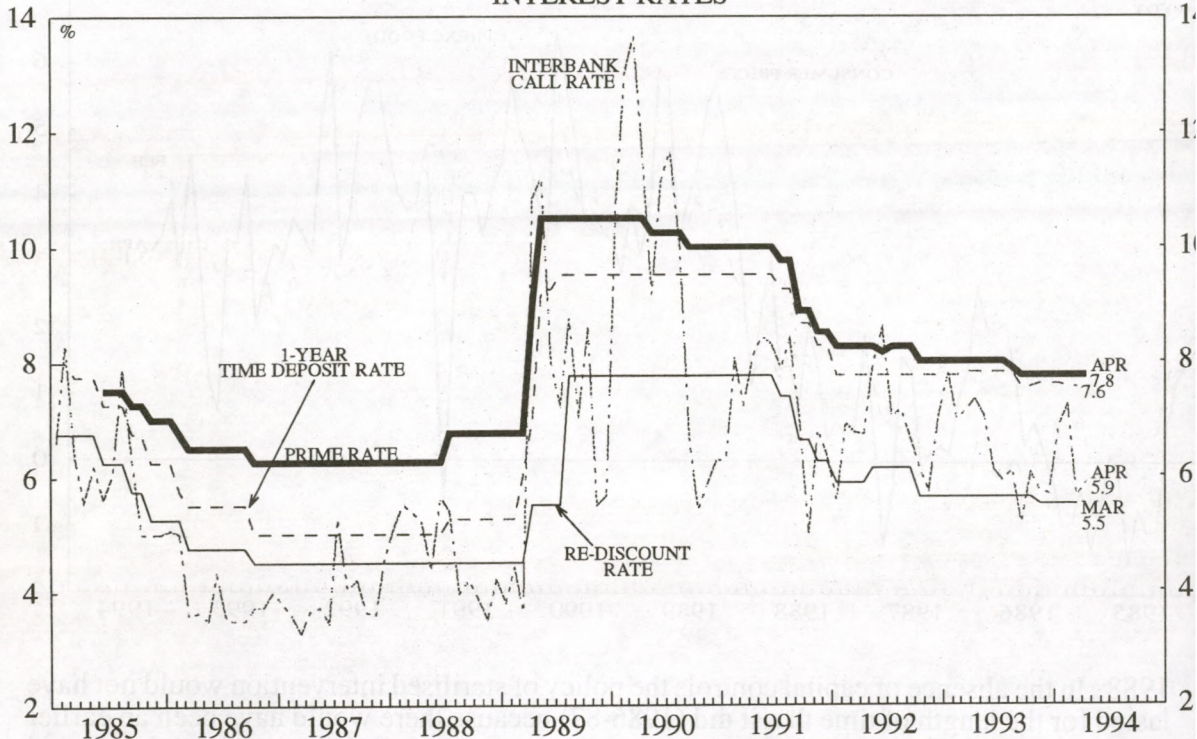
TAIWAN: CHART 7
INFLATION



1988. In the absence of capital controls the policy of sterilised intervention would not have lasted for the length of time that it did (1986-87) because there would have been an earlier upward movement in domestic interest rates which would have (1) undermined the capped currency itself and (2) raised the overall cost to the CBC of its sterilisation operations. The higher inflation which followed the upturn in bank credit, prompted the CBC to tighten and raise interest rates in 1989. This together with the earlier NT\$/US\$ appreciation marked the end of the stimulative managed exchange rate policy. The interest rate then became the main tool of monetary policy with the exchange rate no longer managed as aggressively as it had been over 1986-87. The existence of capital controls has given the CBC the flexibility to set domestic rates at some variance to those in the US given its additional desire to manage the exchange rate.

The upturn in OECD demand over the late 1980s also led a dramatic improvement in Korea's current account surplus. Because Korea also maintains hefty restrictions on the capital account of the balance of payments its monetary footprint over 1987-90 is in some ways similar to that of Taiwan over 1986-89. Like the CBC in Taiwan, the Bank of Korea conducted sterilised intervention to smooth the appreciation of the Won/US\$ rate in the initial stages of its monetary cycle, when the current account surplus widened (1987-88). Like Taiwan bank private credit growth started off weak, but strengthened dramatically after the currency had appreciated to its fullest extent and as the sterilisation instruments unwound. The BOK raised interest rates aggressively over 1989-90 when bank credit had reached its climax and when inflation was well into its upswing. Thus the earlier stimulative exchange rate management in Korea gave way to monetary restraint using higher domestic interest rates later in the credit cycle. As in Taiwan, the cycle in domestic interest rates has to some extent followed that in the US in spite of these capital controls which explicitly preclude international interest rate arbitrage. We now turn to the details concerning the current stage of development of Taiwanese financial markets and the impact on them of a relaxation of foreign exchange controls.

TAIWAN: CHART 8
INTEREST RATES



Banking Sector Liberalisation

Since 1984 the Ministry of Finance (MOF) and the CBC have gradually liberalised the financial system in an attempt to raise its competitiveness -- and so lower the spreads in the financial industry. In the banking sector this was achieved by deregulating interest rates in 1989 and by granting extra licences to 16 new private banks in 1991-92.

Up to July 1989, the CBC could reach its monetary and credit growth targets by imposing maximum and minimum lending rates as well as ceilings on deposit rates. In July 1989, two major amendments to the Banking Law were carried out. These were (i) the removal of a range of maximum and minimum loan rates along with the deposit rate ceiling so that no further interest rate controls existed and (ii) foreign banks were permitted to extend long term loans and accept savings deposits. Towards the end of 1991 and at the start of 1992, the MOF granted licences to 16 new banks in a further attempt to raise the degree of competition in the industry. These banks now have around 4-5% share in retail deposits. Due to strict branching regulations they still have relatively small branch networks compared with the seven major nationwide banks which dominate the retail deposit market. Each new bank started off with seven offices with up to five additional branches permitted per year.

Future reform, which is to take place in two stages focuses on relaxing the branch expansion restrictions for all of the, geographically separate, medium business banks and those which are confined to the Taipei area. Before the regional banks can gain permission to expand their geographical sphere of business they must attain the 8% capital adequacy ratio set by BIS, reduce the ratio of poor and non-performing assets to total advances to under 1.5% and achieve modest rises in net worth and outstanding assets.

Although the restrictions on foreign banks retail deposits business have been gradually relaxed, even today they are not able to compete on an equal footing. The restrictions on the number of branches that foreign banks may operate still prohibits them from significantly eroding the domestic banks market share of retail deposits and to this extent their ability to compete away some of the domestic banks interest spreads is limited. The retail banking industry is still dominated by seven nationwide commercial banks: they account for 63.8% of total retail deposits.

All these changes have introduced a greater element of competition into the banking system which has contributed to an erosion in the monopolistic spreads (prime-deposit rates) over the last 4-5 years, previously the preserve of the 7 dominant commercial banks (Chart 8). A greater degree of competition among the suppliers of short term (one year or less) finance has sprung from the growth in the money market.

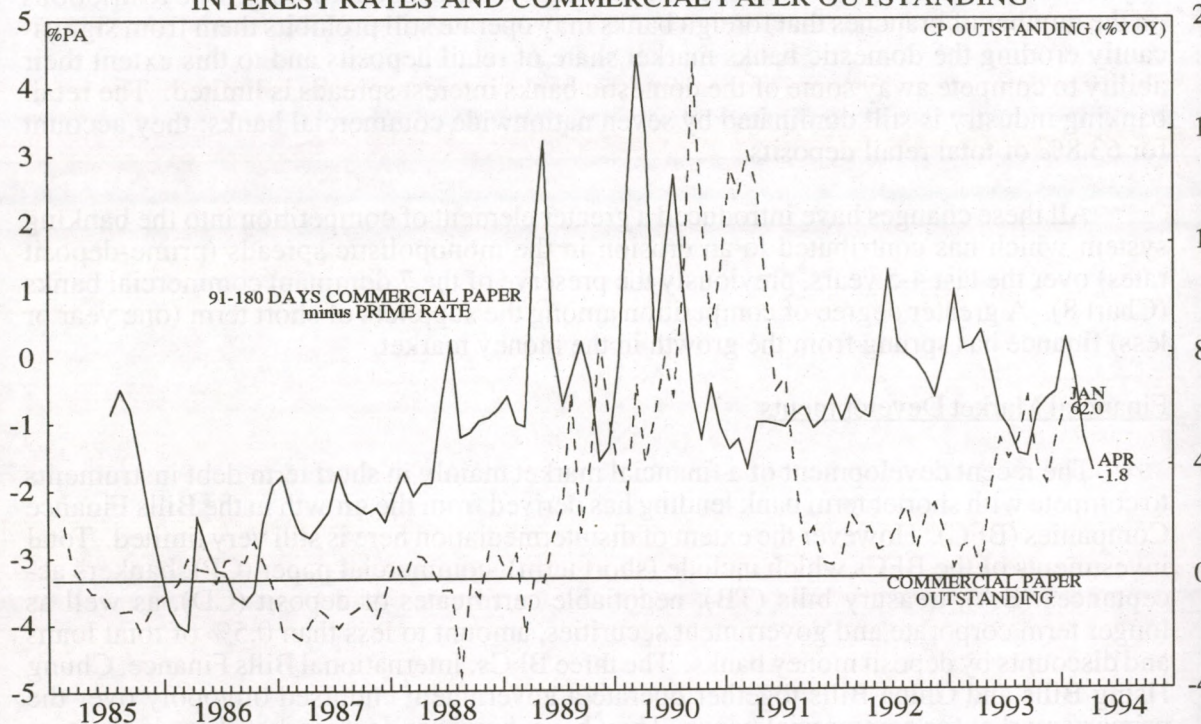
Financial Market Developments

The recent development of a financial market mainly in short term debt instruments to compete with shorter term bank lending has derived from the growth in the Bills Finance Companies (BFC). However the extent of disintermediation here is still very limited. Total investments of the BFCs which include (short term): commercial paper (CP), bankers acceptances (BA), treasury bills (TB), negotiable certificates of deposit (CD), as well as longer term corporate and government securities, amount to less than 0.5% of total loans and discounts by deposit money banks. The three BFCs: International Bills Finance, Chung Hsing Bills and China Bills together operate a government endorsed oligopoly over the primary market for commercial paper. They have, however, lost market share in the secondary market for CP which was opened up to commercial banks in April 1992.

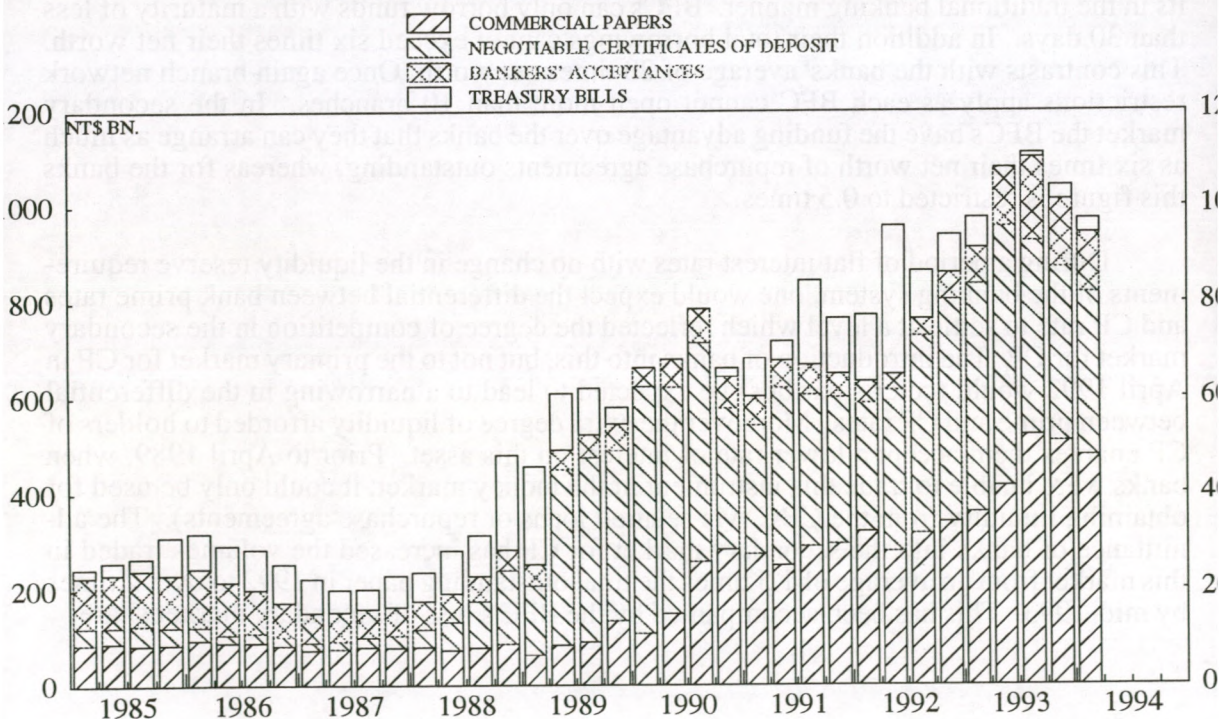
BFCs differ from commercial banks in that they cannot make loans or accept deposits in the traditional banking manner. BFCs can only borrow funds with a maturity of less than 30 days. In addition their total borrowings cannot exceed six times their net worth. This contrasts with the banks' average of 20 times net worth. Once again branch network restrictions apply as each BFC cannot open more than 10 branches. In the secondary market the BFCs have the funding advantage over the banks that they can arrange as much as six times their net worth of repurchase agreements outstanding, whereas for the banks this figure is restricted to 0.5 times.

During a period of flat interest rates with no change in the liquidity reserve requirements of the banking system, one would expect the differential between bank prime rates and CP rate to settle at a level which reflected the degree of competition in the secondary market for CP. The introduction of banks into this, but not to the primary market for CP in April 1992 would (*ceteris paribus*) be expected to lead to a narrowing in the differential between prime and CP rates. Moreover the extra degree of liquidity afforded to holders of CP enables them accept a lower rate of interest on this asset. Prior to April 1989, when banks were unable to trade this instrument in the money market, it could only be used for obtaining liquidity from the CBC (via secured loans or repurchase agreements). The admittance of banks into the secondary market for CP has increased the volumes traded in this market from an average of 1.5 times the total outstanding paper in 1992 to over 2 times by mid-1993. This has been accompanied by the BFC's loss of secondary market share.

TAIWAN: CHART 9
INTEREST RATES AND COMMERCIAL PAPER OUTSTANDING



TAIWAN: CHART 10
OUTSTANDING VOLUMES OF MONEY MARKET BILLS



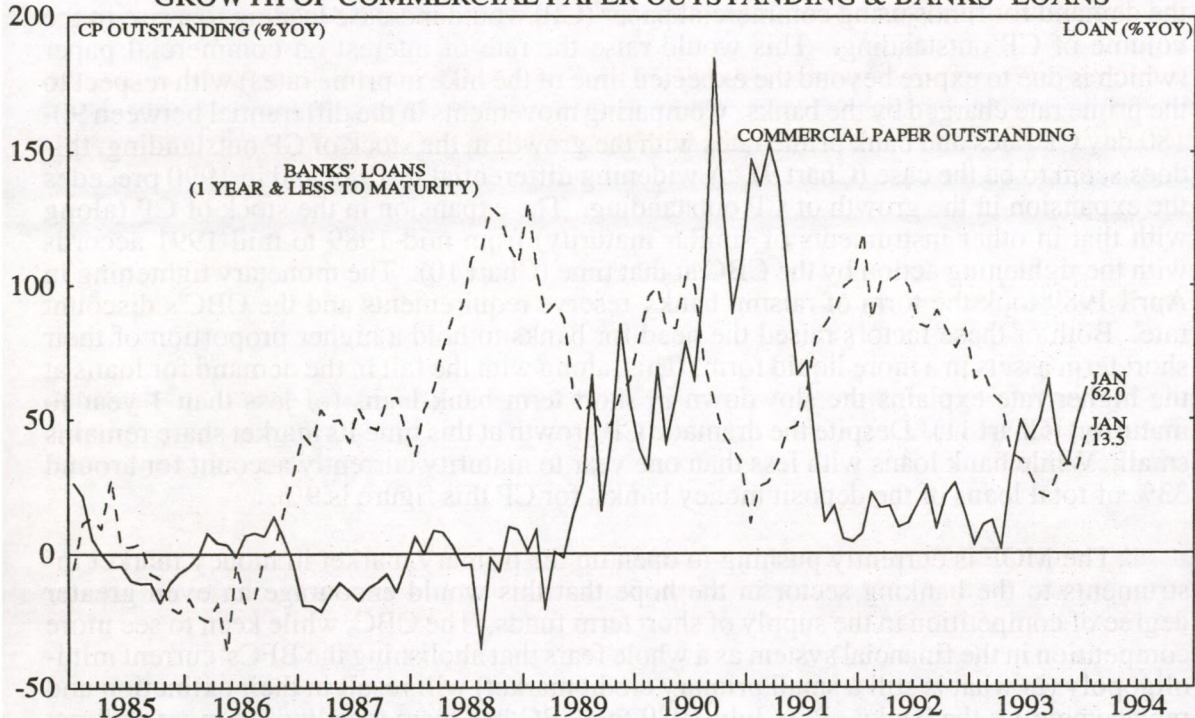
One might expect that when market perceptions are for a rise in the bank prime rate (which is linked to the official administered discount rate) at some time in the future, that the demand for funds using commercial paper (CP) would increase leading to a rise in the volume of CP outstanding. This would raise the rate of interest on commercial paper (which is due to expire beyond the expected time of the hike in prime rates) with respect to the prime rate charged by the banks. Comparing movements in the differential between 90-180 day CP rates and bank prime rates with the growth in the stock of CP outstanding, this does seem to be the case (Chart 9). A widening differential in 1989 and in 1990 precedes the expansion in the growth of CP outstanding. The expansion in the stock of CP (along with that in other instruments of similar maturity) from mid-1989 to mid-1991 accords with the tightening action by the CBC at that time (Chart 10). The monetary tightening in April 1989 took the form of raising banks' reserve requirements and the CBC's discount rate. Both of these factors raised the need for banks to hold a higher proportion of their short term assets in a more liquid form. This, along with the fall in the demand for loans at the higher rate explains the slowdown in short term bank loans (of less than 1 year to maturity) (Chart 11). Despite the dramatic CP growth at this time its market share remains small. While bank loans with less than one year to maturity currently account for around 33% of total loans of the deposit money banks, for CP this figure is 9%.

The MOF is currently pushing to open up the primary market in money market instruments to the banking sector in the hope that this would encourage an even greater degree of competition in the supply of short term funds. The CBC, while keen to see more competition in the financial system as a whole fears that abolishing the BFCs' current mini-oligopoly (in what is still a small primary credit market) will result in their extinction and replacement by the banks. Post July 1989 the CBC has increasingly used more indirect methods to influence the cost of credit. Negotiable CDs, CP and Treasury bills have been among the more commonly used short term instruments in open market operations. Regardless of whether the BFCs survive or not the CBC will still be able to conduct open market operations. However, the longer term development in the market for short term money market paper, in the absence of the BFCs, depends crucially on the CBC's policy towards repurchasing a specific type of instrument and on the future liquidity reserve requirements of the banking system. The ability of the commercial banks to obtain liquidity from the CBC based on an underlying asset is ultimately affected by the CBC's own definition of assets eligible for use as collateral or outright purchase. This may or may not include those created by BFCs.

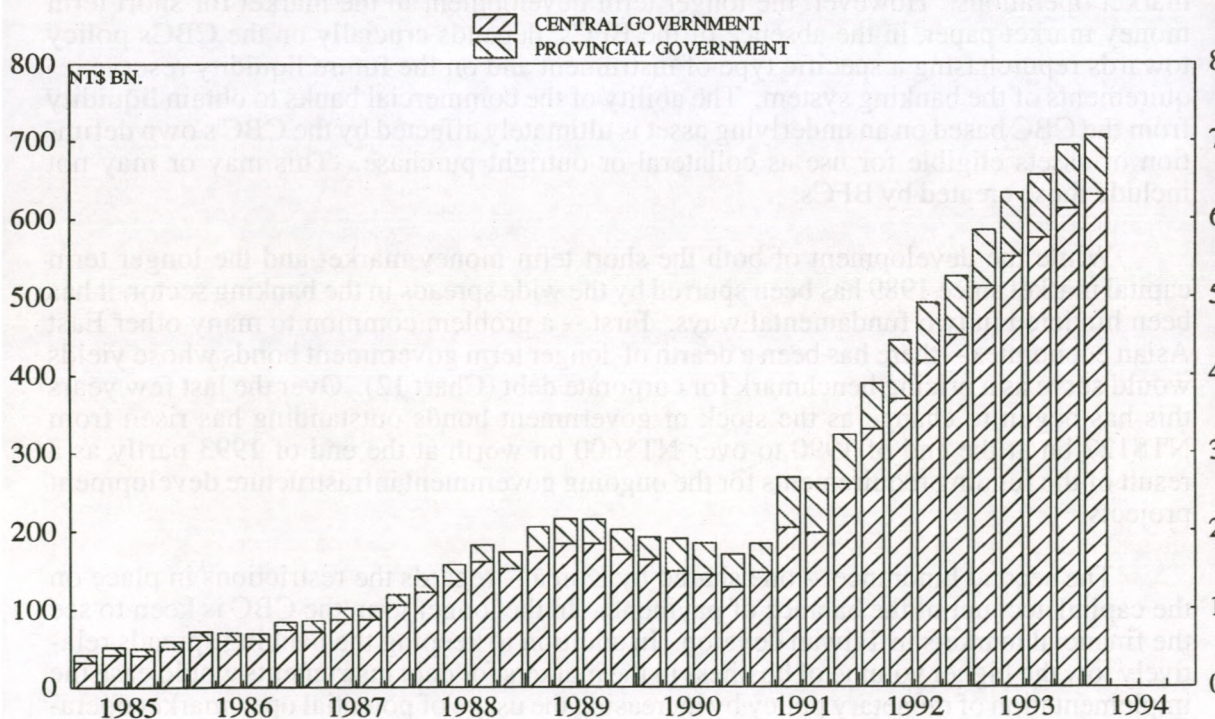
While the development of both the short term money market and the longer term capital market since 1989 has been spurred by the wide spreads in the banking sector, it has been hindered in two fundamental ways. First -- a problem common to many other East Asian economies -- there has been a dearth of longer term government bonds whose yields would serve as a pricing benchmark for corporate debt (Chart 12). Over the last few years this has begun to change as the stock of government bonds outstanding has risen from NT\$127 bn at the end of 1990 to over NT\$600 bn worth at the end of 1993 partly as a result of the funding requirements for the ongoing government infrastructure development projects.

The second hindrance -- one shared by Korea -- regards the restrictions in place on the capital account of the balance of payments. In the longer term the CBC is keen to see the financial markets in Taiwan develop. In addition to keeping the banking spreads relatively low the higher volume of business in the markets for debt instruments would ease the implementation of monetary policy by increasing the usage of potential open market operations instruments. An important precursor to a more established financial market is the

TAIWAN: CHART 11
GROWTH OF COMMERCIAL PAPER OUTSTANDING & BANKS' LOANS



TAIWAN: CHART 12
OUTSTANDING VOLUMES OF GOVERNMENT BONDS



granting of permission to foreign lenders and investors to own unrestricted quantities of Taiwanese instruments of credit. By offering up the possibility of equalising international yields (adjusted for country risk) the secondary market in debt instruments becomes more liquid. The greater element of competition involved ultimately lowers the cost of funds supplied to domestic corporations. However, by relaxing some of the restrictions on the quantity and timing of repatriation of foreign capital and on the foreign ownership limits across a variety of Taiwanese monetary assets, the CBC is giving up one of the tools which allows it to run slightly divergent domestic interest rate and exchange rate policies in the short term.

Currently foreign investors are forbidden from holding the short term money market instruments, although up to a maximum of 10% of the foreign investment limit can be held in the form of government bonds. The limit on the total foreign holding of Taiwanese portfolio investments is currently US\$7.5 bn, with each individual foreign investor limited to \$200 mn. Restrictions on the timing of the transfer of funds into and out of Taiwan exist. The principal sum can only be repatriated after a period of 3 months and the capital gain only after a year has elapsed. Of the funds raised by domestic companies on the international capital markets only \$3 bn can be remitted back to Taiwan. In addition offshore borrowing by all international banks is subject to a ceiling of US\$20 bn or US\$15-50 mn per bank depending on the type.

Implications and Prospects for Further Financial Liberalisation

Given that (1) currently, there is a 4% interest rate premium on 3 month Taiwanese paper over that of US 3 month T-Bills, (2) there is a stable domestic inflation rate around 3-4% (with little chance of a sustainable upturn in prospect) and (3) the currency is currently under slight downward pressure from a narrowing current account surplus, if internationally available, Taiwanese monetary assets would be more attractive to foreign lenders/investors than those of some other S.E. Asian countries. Freeing up the controls necessary to permit international lenders to arbitrage away the interest rate differentials would result in a dramatic rise in capital inflows. The prospect of an appreciation in the NT\$/US\$ that would result forces the CBC to re-evaluate its overall monetary policy in the light of the new linkage between interest rates and the exchange rate. Unless the NT\$/US\$ is able to float freely, the adoption of some form of peg or managed float with the US\$ would cause the domestic monetary and interest rate cycle to follow that in the US more closely than at present.

Given the current low growth in exports and the CBC's history of using the exchange rate as the initial tool of monetary and economic stimulus, relaxation of foreign controls (and allowing the exchange rate to appreciate) is highly unlikely at present. However if the current account surplus continues to narrow the environment could become more conducive to a gradual dismantling of the foreign controls. The upward pressure on the currency would then not be as great as it would if foreign investment restrictions were relaxed today. Over the longer term the more important issue is the loss of an instrument of exchange rate control. The sterilised foreign exchange intervention carried out in 1986-87 would not have been possible for such a length of time in the absence of foreign capital restrictions. This is supported by recent events in Malaysia. Bank Negara Malaysia, the central bank in Malaysia, which used to have relatively few foreign capital restrictions in place could not sustain its sterilised foreign exchange intervention policy from mid 1993 to early 1994 without the aid of capital controls. As in Taiwan these allowed a temporarily undervalued exchange rate to exist while the eventual inflationary upswing in bank credit was delayed.

Across East Asia, where exporters occupy an important place on the economic/political agenda, the exchange rate is an important variable of monetary policy. In Taiwan, any decision by the CBC to undermine the short term flexibility it currently has to meet potentially conflicting domestic interest rate and exchange rate objectives will be a difficult one to make. Nevertheless this would have to be counterbalanced by the further development in the markets for debt securities that would result from the relaxation of some of the foreign capital restrictions. This in turn would increase the sophistication and smoothness of the transmission of monetary policy to the real economy.

SUMMARY AND CONCLUSIONS: The presence of capital controls has insulated Taiwan from the expansionary effects of the strong capital inflows to Asia over the last two years. As a result, its monetary cycle differs that of some other ASEAN countries (which conducted pegged or heavily managed currency policies). Taiwan, which has traditionally received the main impetus for economic growth through the current account, faces an external outlook that augurs for a relatively benign monetary environment. At this (low) point in the monetary cycle the CBC faces two options. Firstly it could reduce domestic rates further, generating an upswing in monetary growth and stronger domestic demand. This would be mildly positive for the equity market. However import growth would likely accelerate further and if it continued to outstrip export growth, there would be a further narrowing of the current account surplus and a weaker NT\$/US\$. After an initial expansion, it is likely that real economic growth would revert back to the current 6% rate. The second and more likely option given Taiwan's traditional preference for export led growth, is to leave domestic rates to continue on a more gentle climb downwards while depreciating the NT\$/US\$ in the expectation of generating faster export growth and an improvement in the current account surplus. A necessary condition for this to be successful in the longer term -- looking ahead into early 1995 -- would be for there to be a sustained upswing in the European and Japanese demand for Taiwanese exports. The implications of this option are for a continuation in the current lukewarm economic growth over the next 12 months.

If, over the course of this year, the first option i.e. higher growth via significant cuts in interest rates is opted for, the faster deterioration in the current account that could result would increase the likelihood of the CBC removing, piece by piece, some of the restrictions on foreign capital. This bodes well for the longer term development of Taiwanese money markets and would prevent the NT\$/US\$ from depreciating by as much as it would otherwise have done.

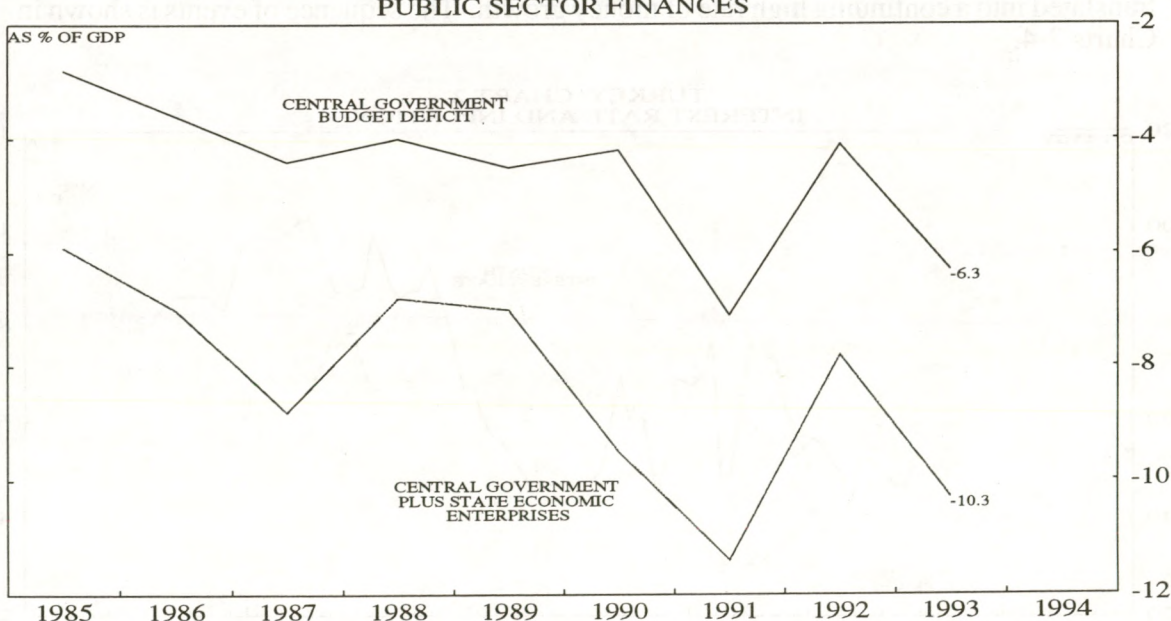
TURKEY CAUSES AND CONSEQUENCES OF THE FINANCIAL CRISIS

For the past four months Turkey has been enveloped in an economic crisis, which has seen the currency lose 60% in value, interest rates soar to as high as 1,000% at times, the stock market collapse and the banking system threatened by potential and actual bank failures. To the casual observer, the lurch from apparent economic buoyancy into chaos must have seemed surprising. Only last year Turkey was the darling of foreign investors in emerging markets. The stockmarket index rose by a phenomenal 213% in US dollar terms, the economy grew by 7.3% in real terms and measured inflation, although very high, remained stable at around its 70% average of the past six years.

Ostensibly the crisis began as a result of the first of what has become a sequence of successive downgradings of Turkey's foreign debt rating by Moody's and Standard and Poor's. In reality, although this may have been the trigger, the crisis had been brewing for some long time. The problems -- out of control public finances, financed by money creation, and an associated loss of demand for the lira -- were foreseen in a previous AMM article on Turkey, in 1992 (Turkey: A Danger of Hyperinflation, Sept-Oct 1992 Vol. 16 No. 5). Only government and central bank policies which amounted to a series of temporary palliatives delayed the inevitable.

The root of the problems has been the inability of the government to tackle the huge public sector deficit (Chart 1). Previous efforts have centred on consolidating the debt of the State Economic Enterprises (SEEs) and bringing a part of the revenues of the myriad of "off budget agencies" within the government budget. However, although much was made of these efforts, although beneficial they were not significant enough to make a serious dent in a deficit in danger of ultimately becoming explosive because of a growing weight of debt interest payments. In 1992, a cosmetic reduction in the deficit was achieved effectively by pushing official government spending (especially interest payments) into 1993. Recently, the public sector deficit has been back up to an annual rate of about 16% of GNP.

TURKEY: CHART 1
PUBLIC SECTOR FINANCES



The previous AMM article showed how, over time, a substantial part of the deficit has been monetised. The creation of money to finance government spending amounts to a tax -- the inflation tax -- on the holders of the monetary base (cash currency and banks' lira deposits at the central bank). To the extent that the deficit is monetised therefore there is not, in a sense, a deficit, but an additional, "hidden", tax. As a result of the very rapid acceleration of inflation in 1988 public debt was reduced from 62% to 43% of GNP, as nominal GNP was increased through inflation and the debt consequently "inflated away". Over time this effect can only be achieved through the creation of more and more rapid inflation. In an economy free from restrictions on capital flows, such as Turkey, it is relatively easy for residents to avoid the "inflation tax" by economising on their holdings of lira. Then, the financing of the deficit can only be achieved through the creation of accelerating inflation, generating a higher rate of "tax" on a relatively smaller and smaller (in real terms) monetary base.

Perhaps in recognition of the growing threat of hyperinflation, the authorities appear to have switched policy towards deficit financing in mid-1992. Debt issues, both domestic and foreign, were sharply increased and borrowing from the central bank (ie monetisation) curtailed. Because prior monetisation meant that Turkey's debt-to-GNP ratio was comparatively low (at least compared with other countries with chronic public finance problems), this switch in policy created the conditions whereby Turkey's economy could, for a time, appear fairly healthy even as public finances continued to deteriorate. During 1993, measured inflation was also held down through the restraint of the administered prices of the SEEs. This artificial suppression of inflation has had a high longer term cost, in that the resultant deterioration of the financial position of the SEEs has added to the public sector deficit.

Unfortunately, the opportunity to reduce money growth and inflation presented by the change in policy towards deficit financing was lost because of the central bank's policy towards the exchange rate. Given the previous (comparatively) low level of outstanding debt, the rapid increase in debt was inevitably associated with large capital inflows. As the central bank conducted a managed exchange rate depreciation, the large capital inflows translated into a continuing high rate of money growth. The sequence of events is shown in Charts 2-4.

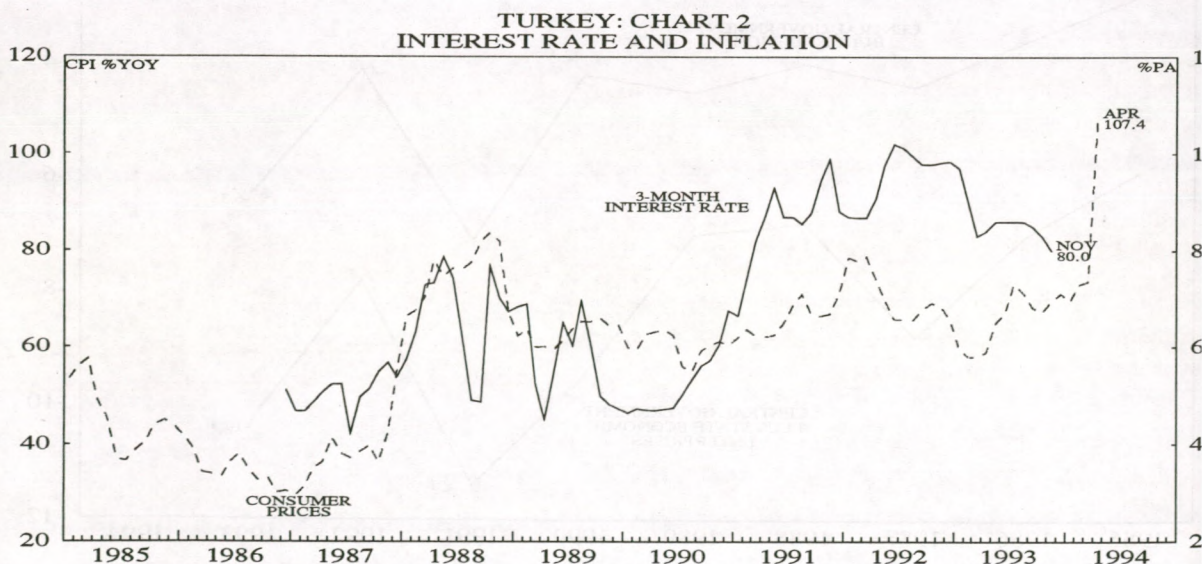


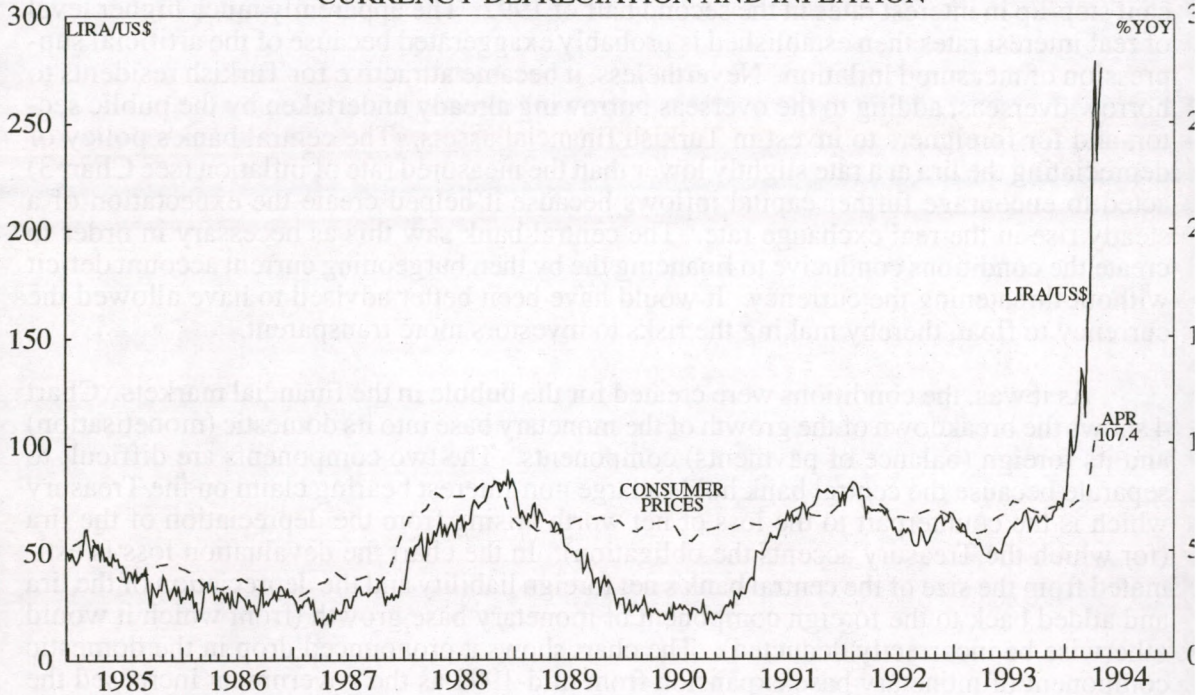
Chart 2 shows that the increased rate of debt issuance was associated with a significant step-up in interest rates in the second half of 1992. The apparently much higher level of real interest rates then established is probably exaggerated because of the artificial suppression of measured inflation. Nevertheless, it became attractive for Turkish residents to borrow overseas, adding to the overseas borrowing already undertaken by the public sector, and for foreigners to invest in Turkish financial assets. The central bank's policy of depreciating the lira at a rate slightly lower than the measured rate of inflation (see Chart 3) acted to encourage further capital inflows because it helped create the expectation of a steady rise in the real exchange rate. The central bank saw this as necessary in order to create the conditions conducive to financing the by then burgeoning current account deficit without threatening the currency. It would have been better advised to have allowed the currency to float, thereby making the risks to investors more transparent.

As it was, the conditions were created for the bubble in the financial markets. Chart 4 shows the breakdown of the growth of the monetary base into its domestic (monetisation) and its foreign (balance of payments) components. The two components are difficult to separate because the central bank holds a large non-interest bearing claim on the Treasury which is the counterpart to the loss of net worth arising from the depreciation of the lira (for which the Treasury accepts the obligation). In the chart the devaluation loss is estimated from the size of the central bank's net foreign liability and the depreciation of the lira and added back to the foreign component of monetary base growth (from which it would otherwise be incorrectly deducted). The chart shows a pronounced drop in the domestic component of monetary base expansion from mid-1992 as the government increased the volume of debt financing. However, monetary base growth did not slow appreciably. As capital inflows soared to approximately US\$8 billion during 1993, the foreign component of monetary base growth rose sharply. Liquidity in the economy became very buoyant as the balance of payments generated monetary expansion failed to translate quite as quickly into an acceleration of inflation and as inflation expectations were, perhaps, held back to a degree by the government's direct restraint of administered prices. The bubble in the stockmarket then became self-reinforcing as portfolio capital inflows were attracted into the stockmarket.

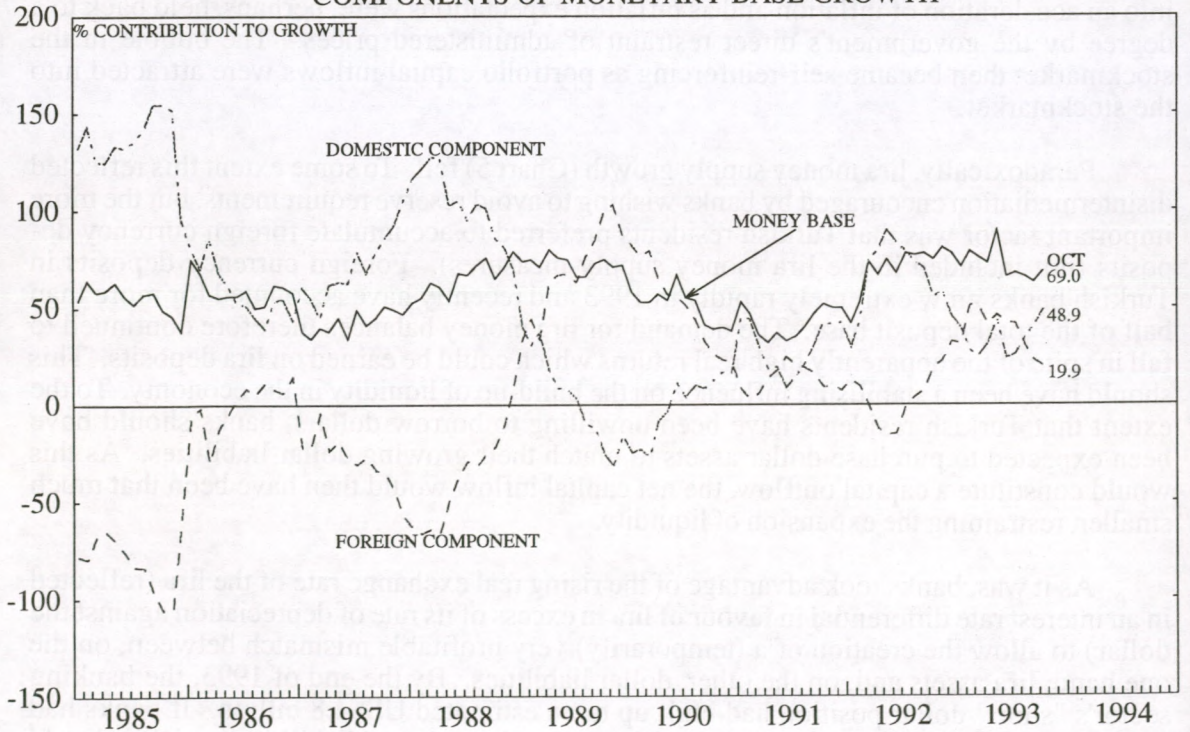
Paradoxically, lira money supply growth (Chart 5) fell. To some extent this reflected disintermediation encouraged by banks wishing to avoid reserve requirements, but the more important factor was that Turkish residents preferred to accumulate foreign currency deposits (not included in the lira money supply measures). Foreign currency deposits in Turkish banks grew extremely rapidly in 1993 and recently have accounted for more than half of the total deposit base. The demand for lira money balances therefore continued to fall in spite of the apparently high real returns which could be earned on lira deposits. This should have been a stabilising influence on the build-up of liquidity in the economy. To the extent that Turkish residents have been unwilling to borrow dollars, banks should have been expected to purchase dollar assets to match their growing dollar liabilities. As this would constitute a capital outflow, the net capital inflow would then have been that much smaller, restraining the expansion of liquidity.

As it was, banks took advantage of the rising real exchange rate of the lira (reflected in an interest rate differential in favour of lira in excess of its rate of depreciation against the dollar) to allow the creation of a (temporarily) very profitable mismatch between, on the one hand, lira assets and, on the other, dollar liabilities. By the end of 1993, the banking sector's "short" dollar position had built up to an estimated US\$4.8 billion. If banks had instead converted lira assets into dollar assets to match assets and liabilities (and this should

TURKEY: CHART 3
CURRENCY DEPRECIATION AND INFLATION



TURKEY: CHART 4
COMPONENTS OF MONETARY BASE GROWTH



have been forced by the banking supervisory authorities) the net capital inflow in 1993 would have been US\$3.2 billion instead of US\$8 billion. To this extent, also, the rise in the real exchange rate was allowed to become self-reinforcing.

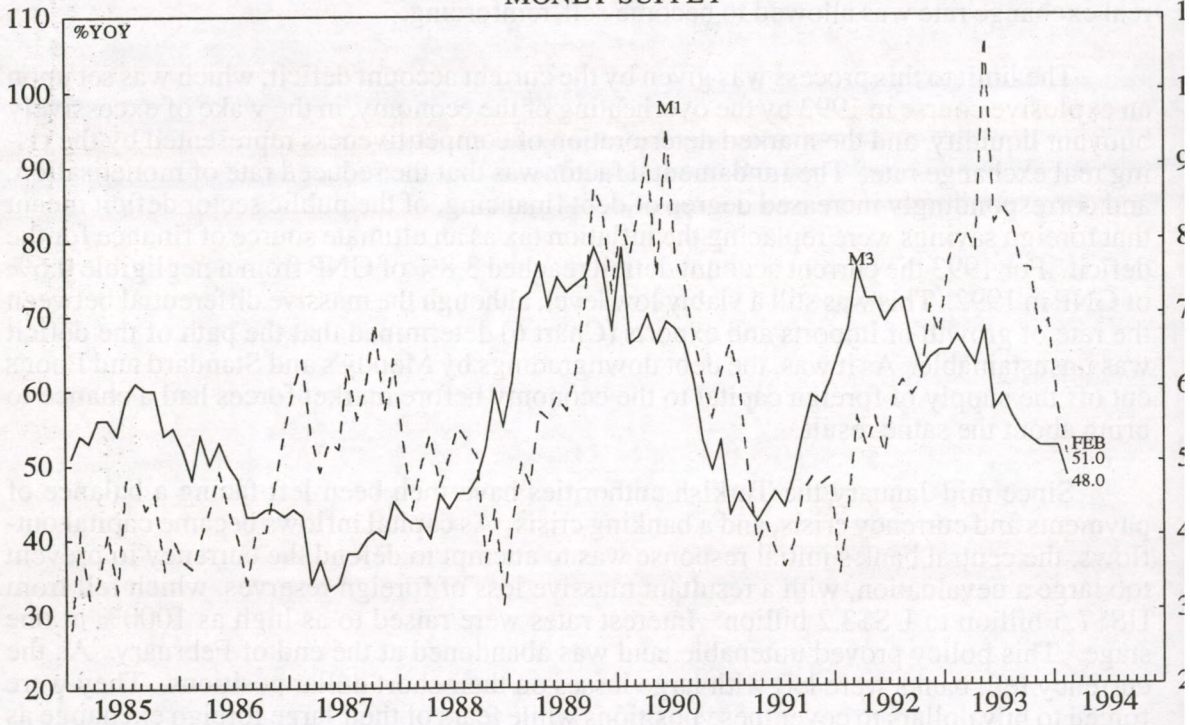
The limit to this process was given by the current account deficit, which was set upon an explosive course in 1993 by the overheating of the economy, in the wake of excessively buoyant liquidity, and the marked deterioration of competitiveness represented by the rising real exchange rate. The fundamental factor was that the reduced rate of monetisation, and correspondingly increased degree of debt financing, of the public sector deficit meant that foreign savings were replacing the inflation tax as an ultimate source of finance for the deficit. For 1993 the current account deficit reached 3.8% of GNP from a negligible 0.6% of GNP in 1992. This was still a viably low level, although the massive differential between the rate of growth of imports and exports (Chart 6) determined that the path of the deficit was unsustainable. As it was, the debt downgradings by Moody's and Standard and Poor's cut off the supply of foreign capital to the economy before market forces had a chance to bring about the same result.

Since mid-January the Turkish authorities have then been left facing a balance of payments and currency crisis, and a banking crisis. As capital inflows became capital outflows, the central bank's initial response was to attempt to defend the currency to prevent too large a devaluation, with a resultant massive loss of foreign reserves, which fell from US\$7.5 billion to US\$3.2 billion. Interest rates were raised to as high as 1000% at one stage. This policy proved untenable, and was abandoned at the end of February. As the currency fell, banks were left with large losses on their short dollar positions. They were forced to buy dollars to cover these positions while fears of their large foreign exchange as well as credit losses undermined public confidence in the banking system. The public transferred deposits from lesser capitalised banks and also converted bank deposits into cash currency resulting in a withdrawal of US\$3.5 billion of foreign exchange denominated deposits and a sharp slowing in the rate of growth of lira deposits. Withdrawals from foreign currency accounts were exacerbated by fears that the government might forcibly convert foreign currency deposits into lira.

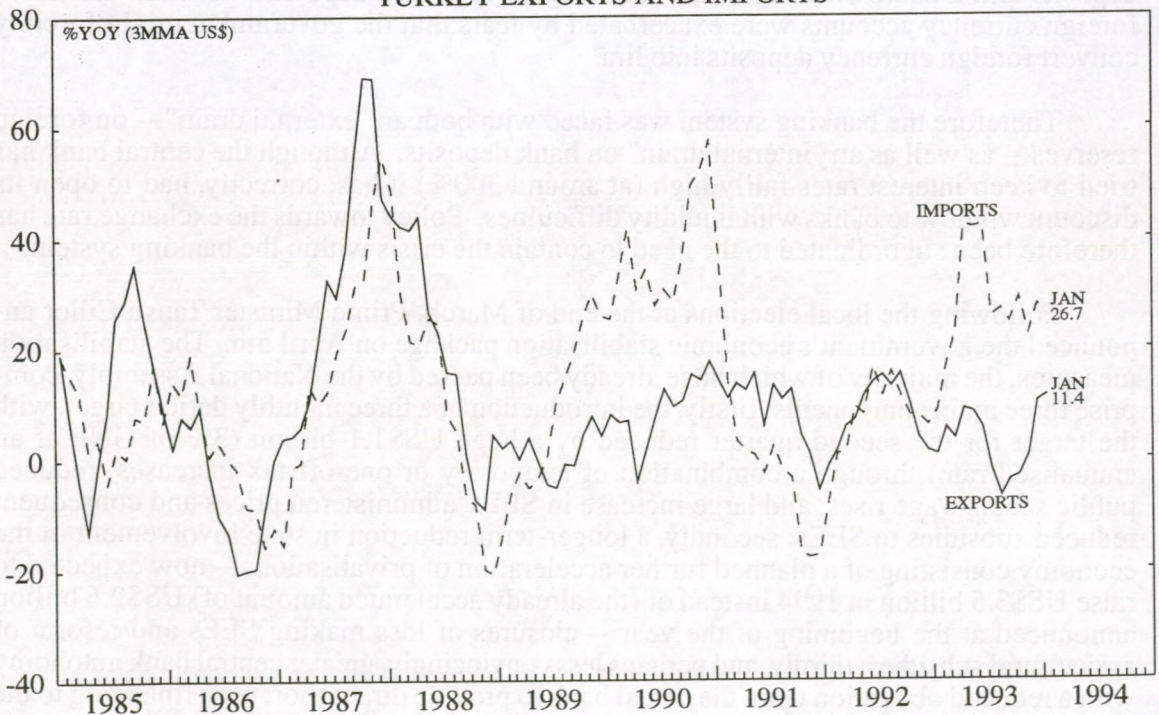
Therefore the banking system was faced with both an "external drain" -- on foreign reserves -- as well as an "internal drain" on bank deposits. Although the central bank has tried to keep interest rates fairly high (at around 300%) it has, correctly, had to open its discount window to banks with liquidity difficulties. Policy towards the exchange rate has therefore been subordinated to the need to contain the crisis within the banking system.

Following the local elections at the end of March, Prime Minister Tansu Ciller announced the government's economic stabilisation package on April 5th. The stabilisation measures, the majority of which have already been passed by the National Assembly, comprise three main components: firstly, the introduction of a three monthly deficit target, with the target for the second quarter reduced by a huge US\$1.1 billion (3% of GNP at an annualised rate) through a combination of temporary or one-off tax increases, reduced public sector wage rises, and large increase in SEEs' administered prices and consequent reduced subsidies to SEEs; secondly, a longer-term reduction in state involvement in the economy consisting of a planned further acceleration of privatisations -- now expected to raise US\$3.5 billion in 1994 instead of (the already accelerated amount of) US\$2.6 billion announced at the beginning of the year -- closures of loss making SEEs and reform of agricultural subsidies; thirdly, and perhaps less convincingly, greater central bank autonomy with a reduced obligation upon the central bank to provide direct short term financing to the government.

**TURKEY: CHART 5
MONEY SUPPLY**



**TURKEY: CHART 6
TURKEY EXPORTS AND IMPORTS**



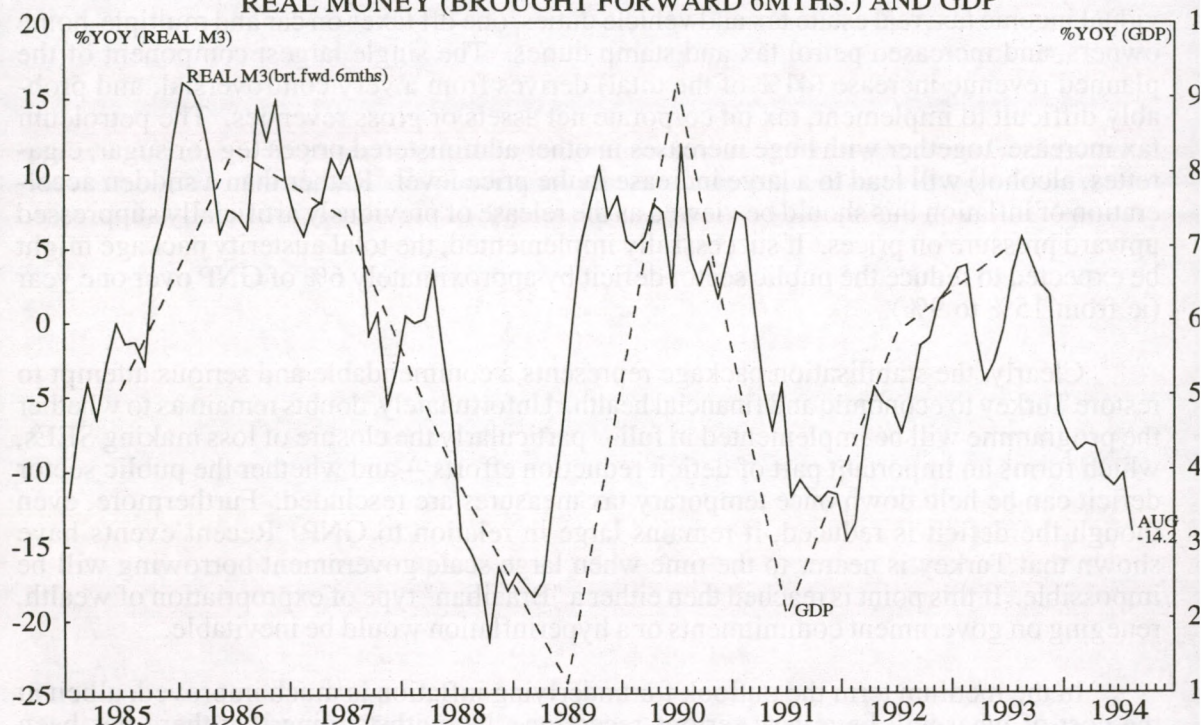
The tax measures proposed in the package are intended to produce additional revenue equivalent to US\$2 billion in 1994. They include surcharges on corporate and individual income tax, real estate tax and vehicle duties, one off taxes on car and multiple-home owners, and increased petrol tax and stamp duties. The single largest component of the planned revenue increase (41% of the total) derives from a very controversial, and probably difficult to implement, tax on corporate net assets or gross revenues. The petroleum tax increase, together with huge increases in other administered prices (eg for sugar, cigarettes, alcohol) will lead to a large increase in the price level. Rather than a sudden acceleration of inflation this should be viewed as the release of previously artificially suppressed upward pressure on prices. If successfully implemented, the total austerity package might be expected to reduce the public sector deficit by approximately 6% of GNP over one year (ie from 15% to 9%).

Clearly, the stabilisation package represents a commendable and serious attempt to restore Turkey to economic and financial health. Unfortunately, doubts remain as to whether the programme will be implemented in full -- particularly the closure of loss making SEEs, which forms an important part of deficit reduction efforts -- and whether the public sector deficit can be held down once temporary tax measures are rescinded. Furthermore, even though the deficit is reduced, it remains large in relation to GNP. Recent events have shown that Turkey is nearer to the time when large scale government borrowing will be impossible. If this point is reached then either a "Brazilian" type of expropriation of wealth, reneging on government commitments or a hyperinflation would be inevitable.

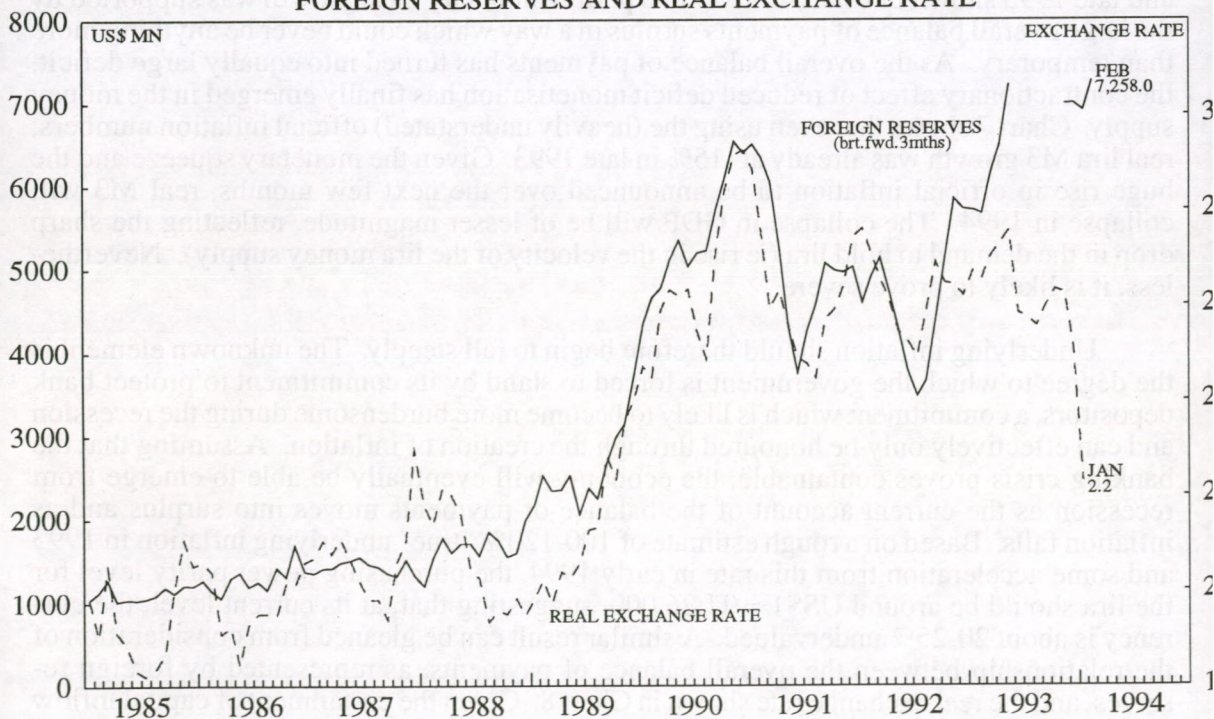
In the medium term the outlook for underlying inflation is much improved, albeit at the cost of what will be a very serious recession. Notwithstanding that there has been substantial domestic credit extension by the central bank, including to the government, the huge loss of foreign reserves has meant that the monetary squeeze has been severe. This is the ultimate consequence of the reduced rate of deficit monetisation between mid-1992 and late 1993 shown in Chart 4. Over this period monetary base growth was supported by the large overall balance of payments surplus in a way which could never be anything more than temporary. As the overall balance of payments has turned into equally large deficit, the contractionary effect of reduced deficit monetisation has finally emerged in the money supply. Chart 7 shows that even using the (heavily understated) official inflation numbers, real lira M3 growth was already at -15% in late 1993. Given the monetary squeeze and the huge rise in official inflation to be announced over the next few months, real M3 will collapse in 1994. The collapse in GDP will be of lesser magnitude, reflecting the sharp drop in the demand to hold lira (ie rise in the velocity of the lira money supply). Nevertheless, it is likely to prove severe.

Underlying inflation should therefore begin to fall steeply. The unknown element is the degree to which the government is forced to stand by its commitment to protect bank depositors, a commitment which is likely to become more burdensome during the recession and can effectively only be honoured through the creation of inflation. Assuming that the banking crisis proves containable, the economy will eventually be able to emerge from recession as the current account of the balance of payments moves into surplus and as inflation falls. Based on a rough estimate of 100-120% "true" underlying inflation in 1993 and some acceleration from this rate in early 1994, the purchasing power parity level for the lira should be around US\$1 = TL26,000, suggesting that, at its current level, the currency is about 20-25% undervalued. A similar result can be gleaned from consideration of the relationship between the overall balance of payments, as represented by foreign reserves, and the real exchange rate shown in Chart 8. Given the curtailment of capital inflow

TURKEY: CHART 7
REAL MONEY (BROUGHT FORWARD 6MTHS.) AND GDP



TURKEY: CHART 8
FOREIGN RESERVES AND REAL EXCHANGE RATE



(notwithstanding the role now being played by the IMF) and the effects of the domestic banking crisis, the currency will remain undervalued until the current account of the balance of payments has moved into surplus. The fundamental process is that, to the extent that the public sector deficit has not been monetised, it has had to be financed by real savings. In 1993 it was foreign savings which filled the gap, but now it has to be domestic savings, net of domestic private investment. The transition to a larger domestic private savings surplus is necessarily associated with a weak currency (relative to purchasing power parity) and high real interest rates.

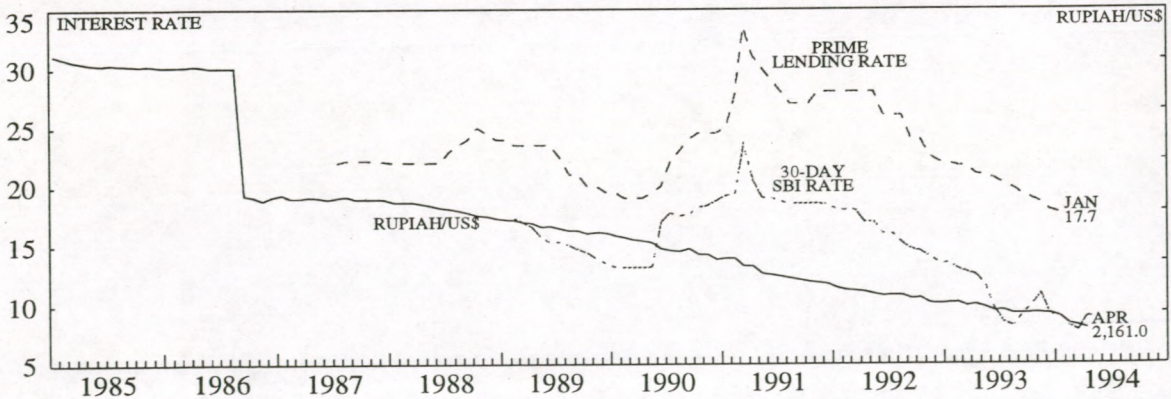
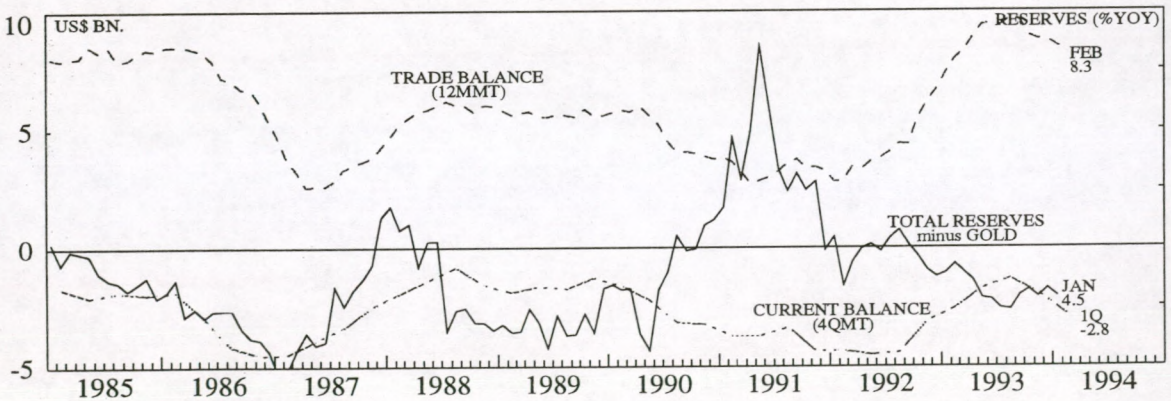
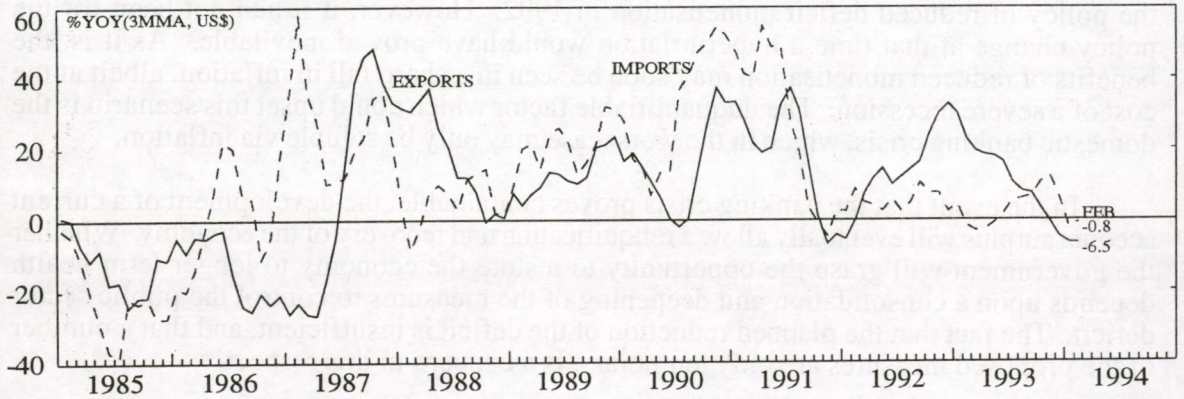
FORECAST: In 1994 Turkey has finally been suffering the consequences of years of out-of-control public finances financed by the creation of inflation. The exact chain of events which led to the balance of payments and financial crisis this year was, ironically, begun by the policy of reduced deficit monetisation in 1992. However, if it had not been for the policy change at that time a hyperinflation would have proved inevitable. As it is, the benefits of reduced monetisation may soon be seen in a sharp fall in inflation, albeit at the cost of a severe recession. The unquantifiable factor which could upset this scenario is the domestic banking crisis, which in the worst case may only be soluble via inflation.

In the event that the banking crisis proves containable, the development of a current account surplus will eventually allow a reliquification and recovery of the economy. Whether the government will grasp the opportunity to restore the economy to longer term health depends upon a consolidation and deepening of the measures to control the public sector deficit. The fact that the planned reduction of the deficit is insufficient, and that a number of the proposed measures are only temporary, is a concern in this respect.

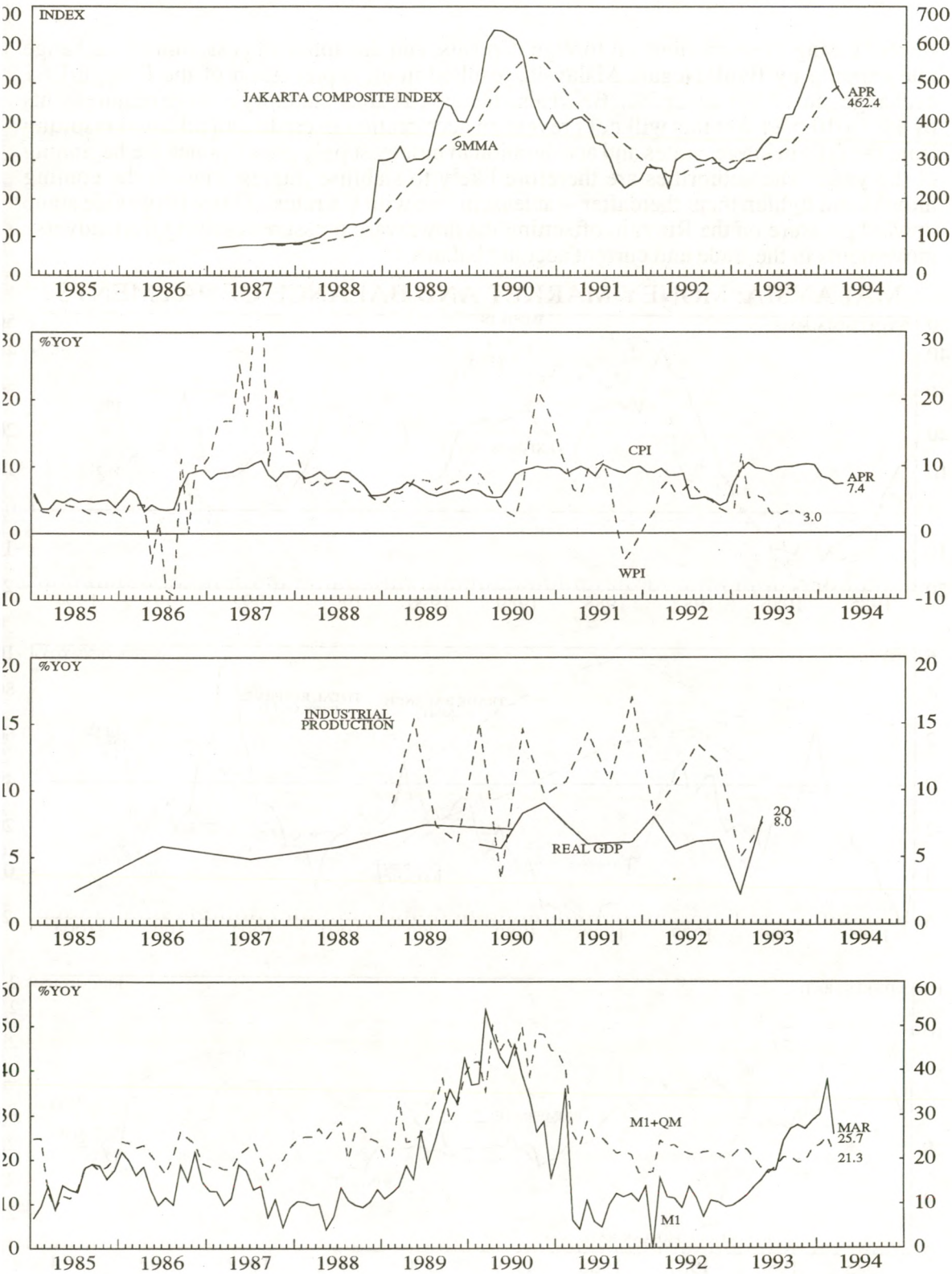
INDONESIA: OECD GROWTH TO BOOST EXPORTS

OECD recovery in the next 12-18 months will boost Indonesia's export earnings through export market growth and rises in oil and other commodity prices. In addition, recent and likely future rises in US interest rates will allow the Indonesian authorities to raise rates to curb expanding money supply growth, while still pursuing a gradual depreciation of the Rupiah against the US\$. However, if credit demand remains strong in the near term, this could prompt the imposition of lending controls. The money supply overhang and continued deregulation of the real economy should allow strong output and earnings growth for at least another year.

INDONESIA: MONEY MARKET AND BALANCE OF PAYMENTS



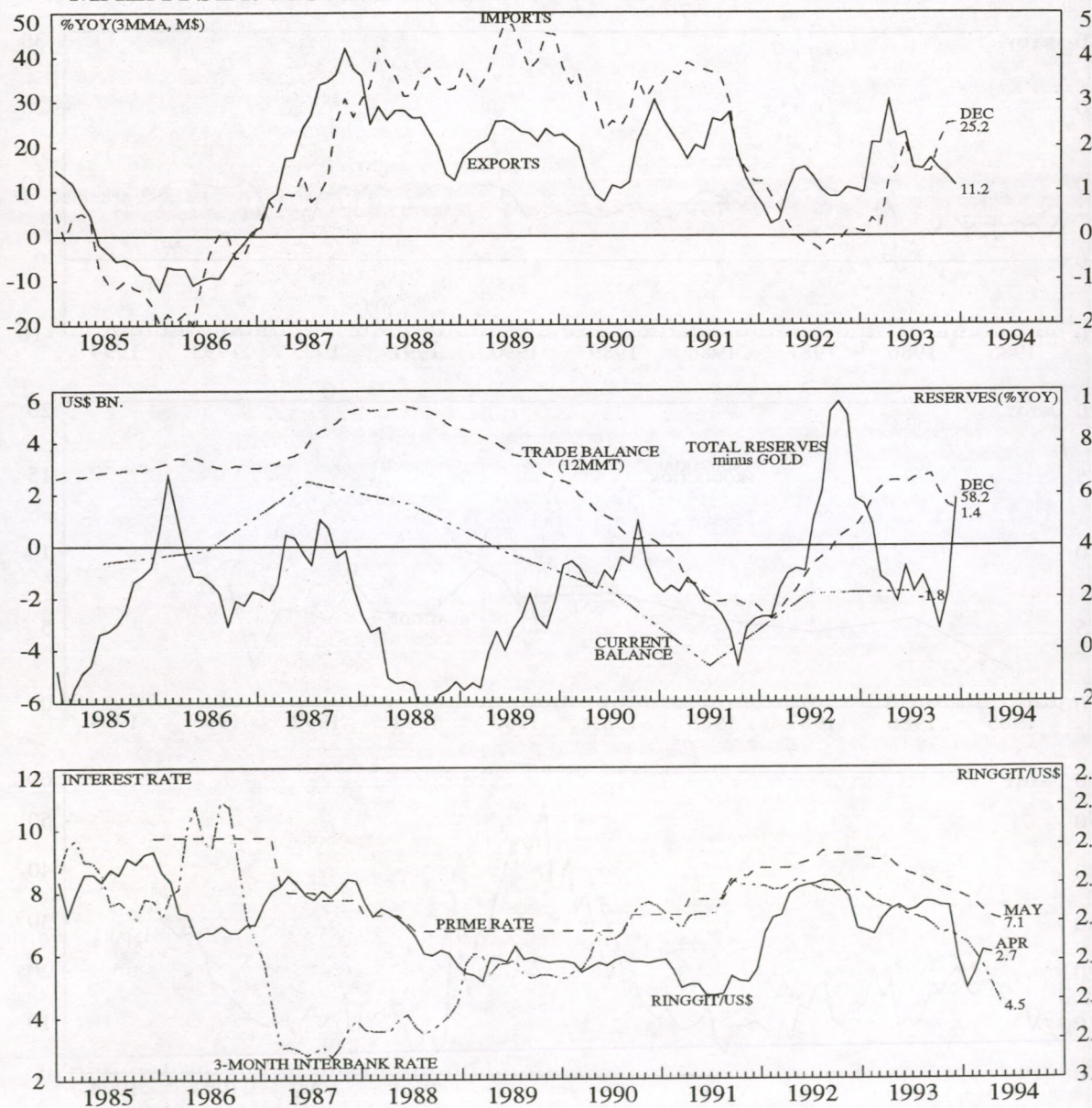
INDONESIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



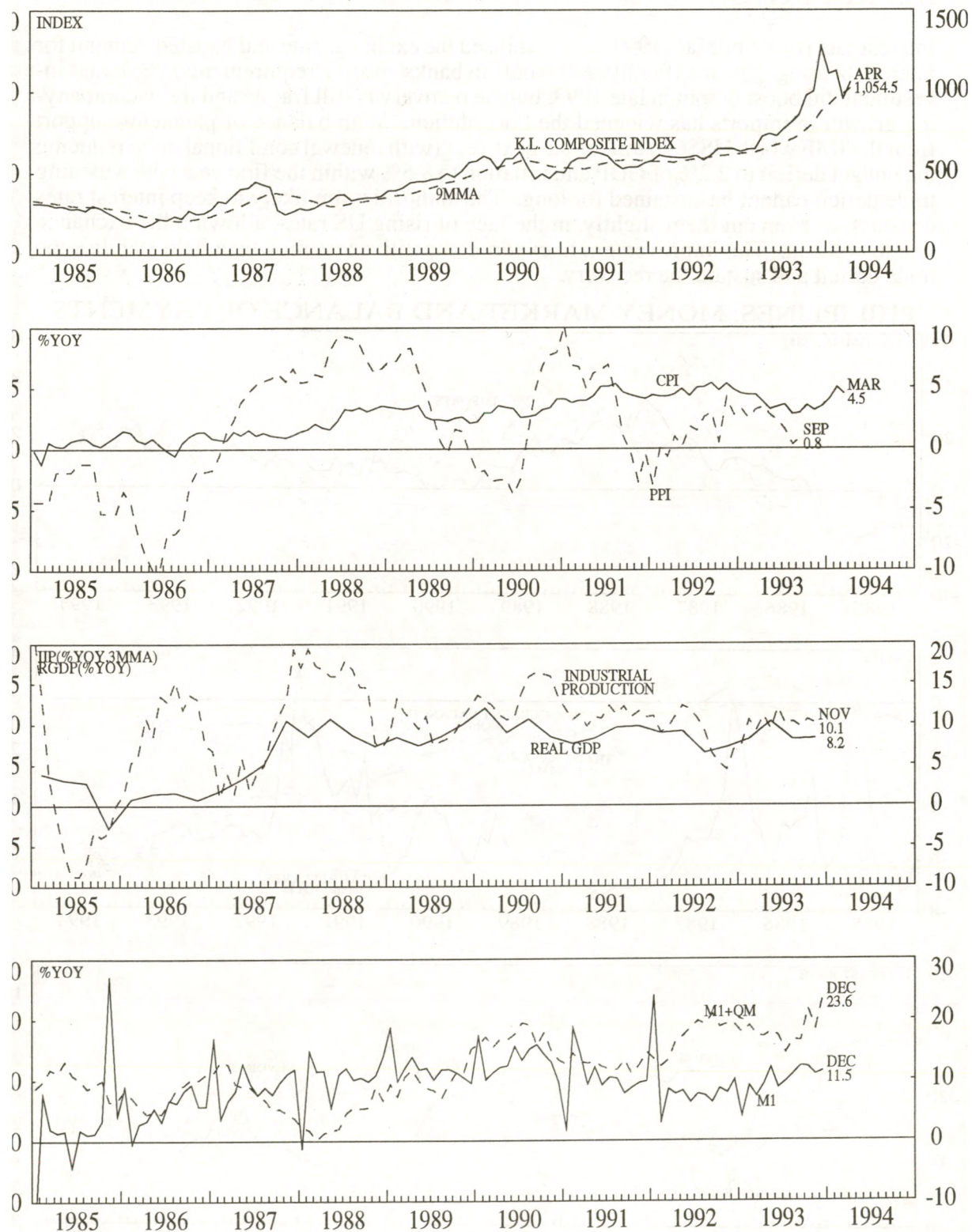
MALAYSIA: MONETARY TIGHTENING ON HORIZON

Recent easing of restrictions on foreign deposits, and the apparent cessation of exchange rate capping by Bank Negara Malaysia, resulted in an appreciation of the Ringgit/US\$ exchange rate of just under 3%. BNM also increased banks' statutory reserve requirements by 1% (to 10.5%), but this will not prevent an acceleration in credit and inflation resulting from the falls in interest rates and acceleration in money supply growth since the beginning of the year. The authorities are therefore likely to stabilise interest rates in the coming months and tighten them thereafter -- at least in line with US rates. This will provide some upward pressure on the Ringgit, offsetting the downward pressure resulting from adverse movements in the trade and current account balances.

MALAYSIA: MONEY MARKET AND BALANCE OF PAYMENTS



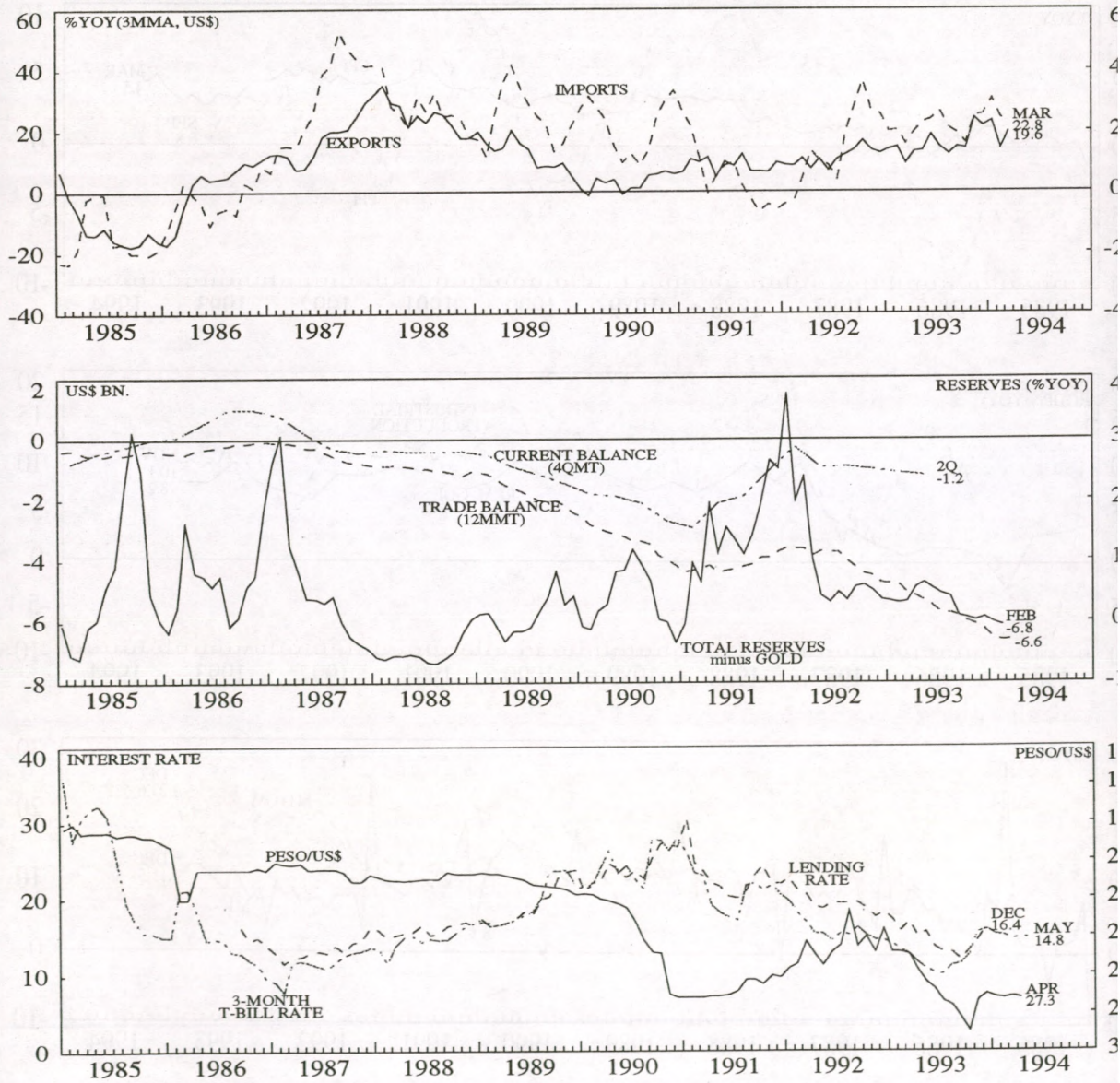
MALAYSIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



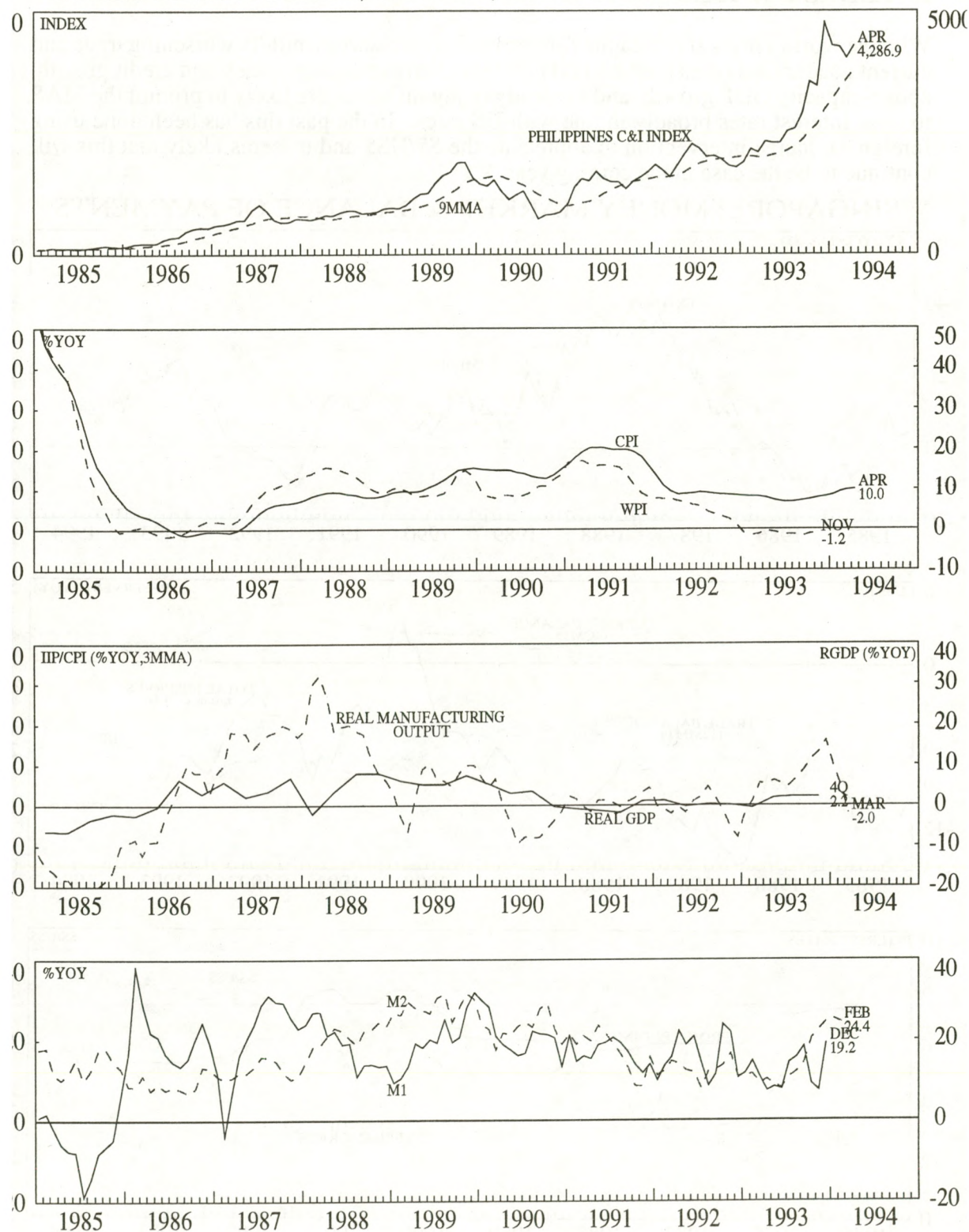
PHILIPPINES: FRAGILE RECOVERY JUSTIFIES CURRENCY DEPRECIATION

Interest rate rises since late 1993 have stabilised the exchange rate and boosted demand for interest-bearing deposits (facilitated by cuts in banks' reserve requirements). Buoyant investment did boost output in late 1993, but the recovery is still fragile and the accompanying growth in imports has widened the trade deficit. With balance of payments support from the IMF worth US\$650 mn for the next year (with renewal conditional upon reducing the budget deficit to 2.2% of GDP and inflation to 8.5% within the first year) the widening trade deficit cannot be sustained for long. The authorities are likely to keep interest rates constant, or even cut them slightly, in the face of rising US rates, allowing the exchange rate to weaken. The improvement in export competitiveness may then help stabilise the trade deficit and sustain the recovery.

PHILIPPINES: MONEY MARKET AND BALANCE OF PAYMENTS



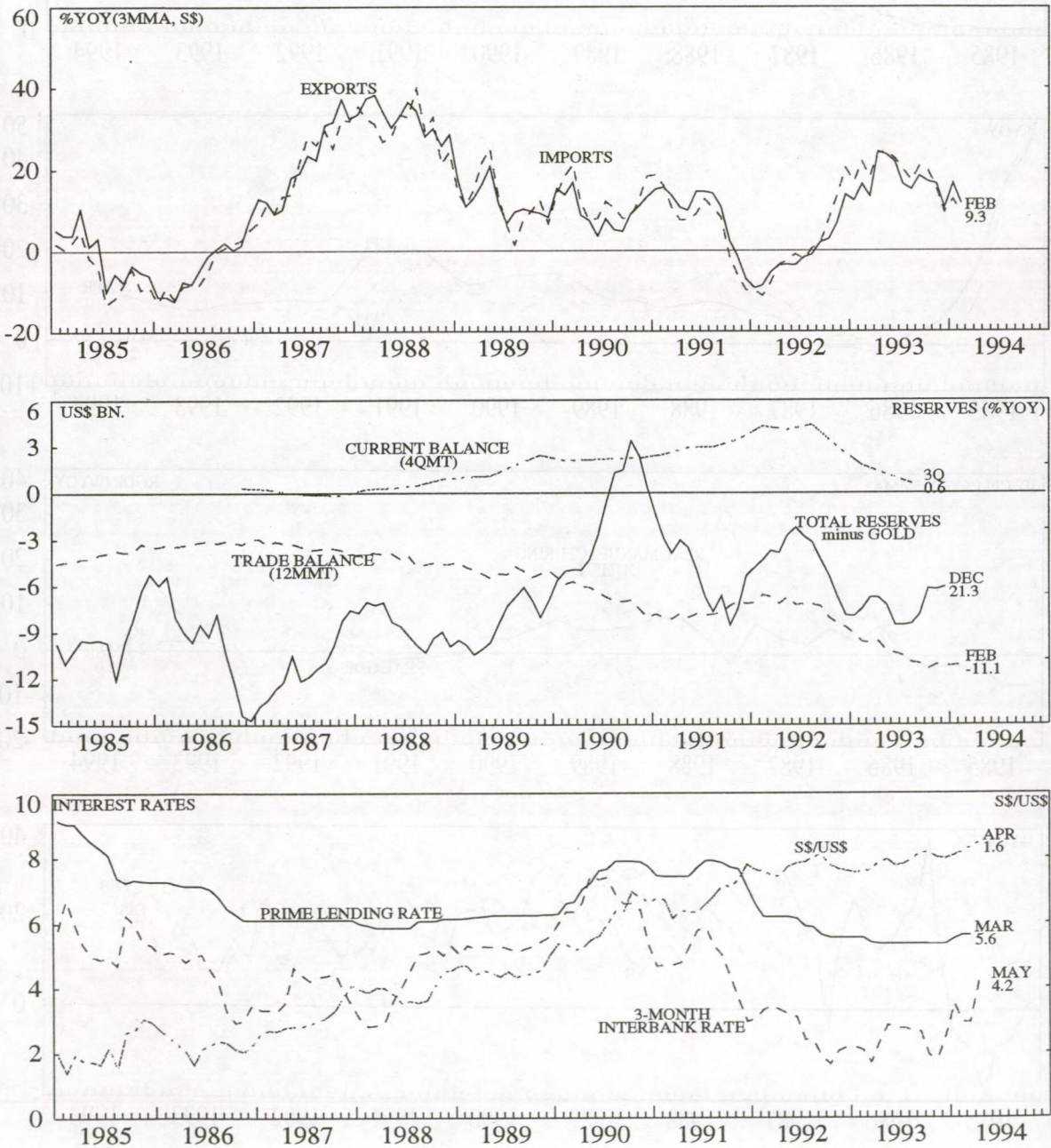
PHILIPPINES: MONEY, OUTPUT, GOODS AND ASSET PRICES



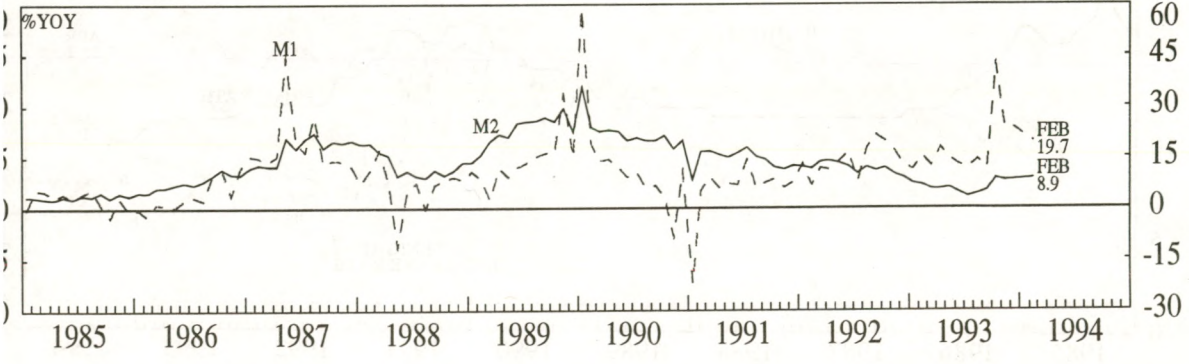
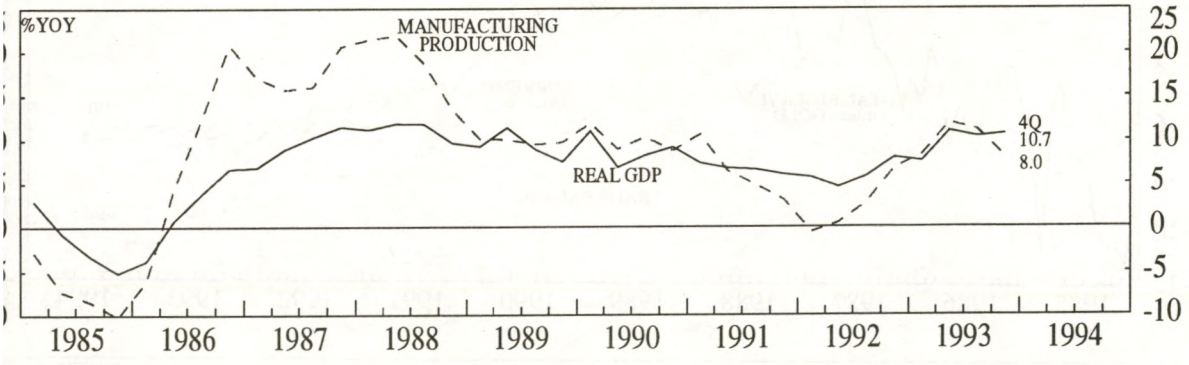
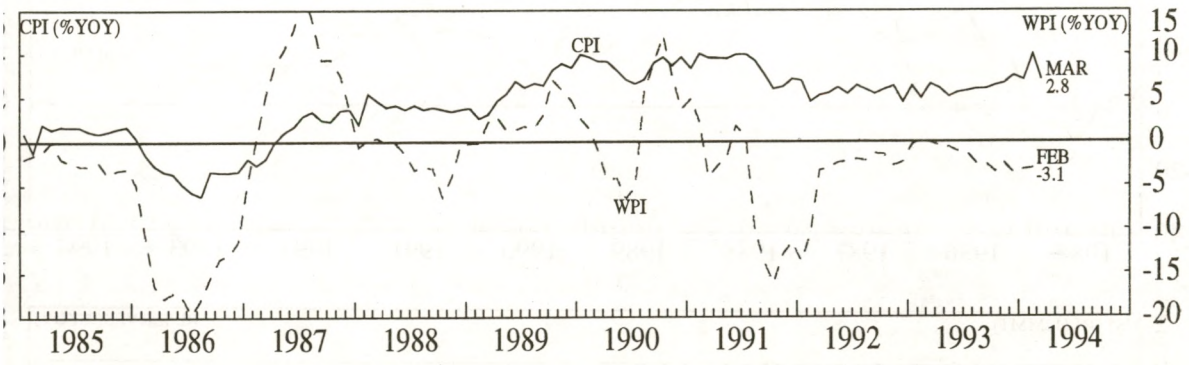
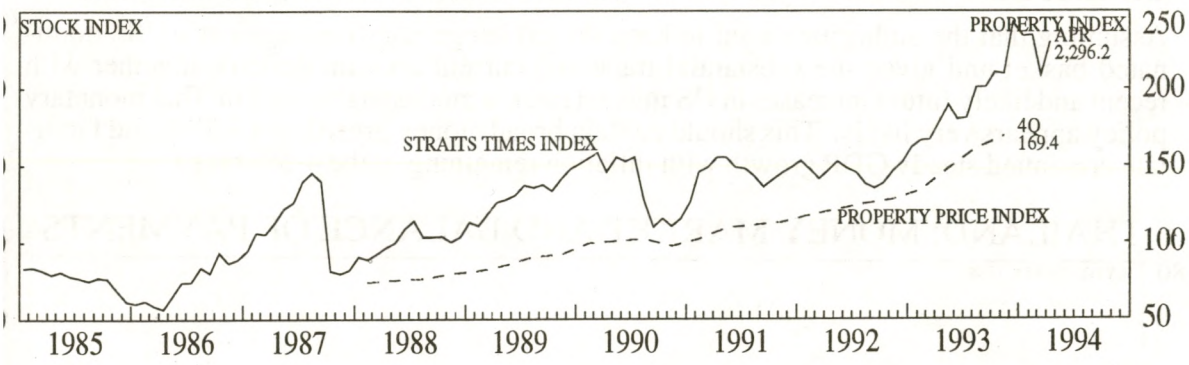
SINGAPORE: CURRENCY APPRECIATION WILL LIFT INTEREST RATES

With the world's highest per-capita foreign exchange reserves, mildly worsening trade and current account balances pose no real problem. But expanding money and credit growth, above-capacity GDP growth, and modestly rising inflation, are likely to prompt the MAS to raise interest rates broadly in line with US rates. In the past this has been done using foreign exchange intervention to appreciate the S\$/US\$ and it seems likely that this will continue to be the case in the coming year.

SINGAPORE: MONEY MARKET & BALANCE OF PAYMENTS



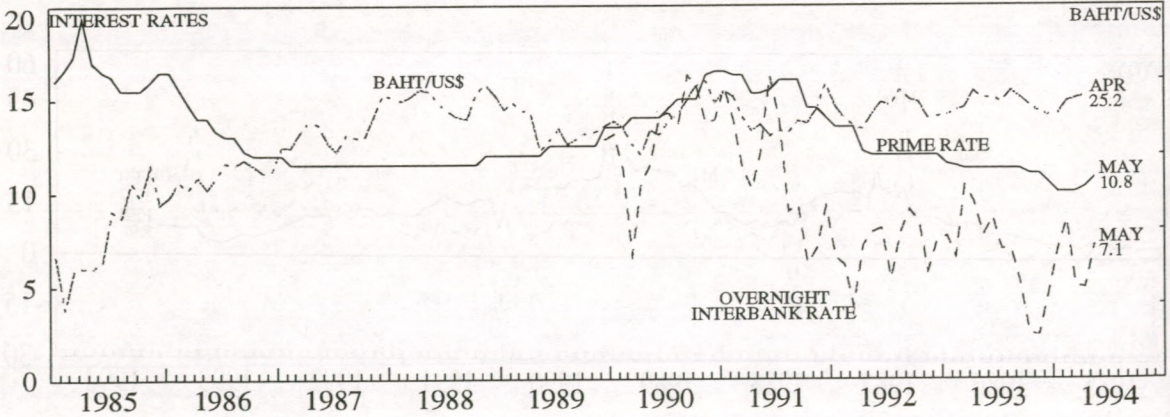
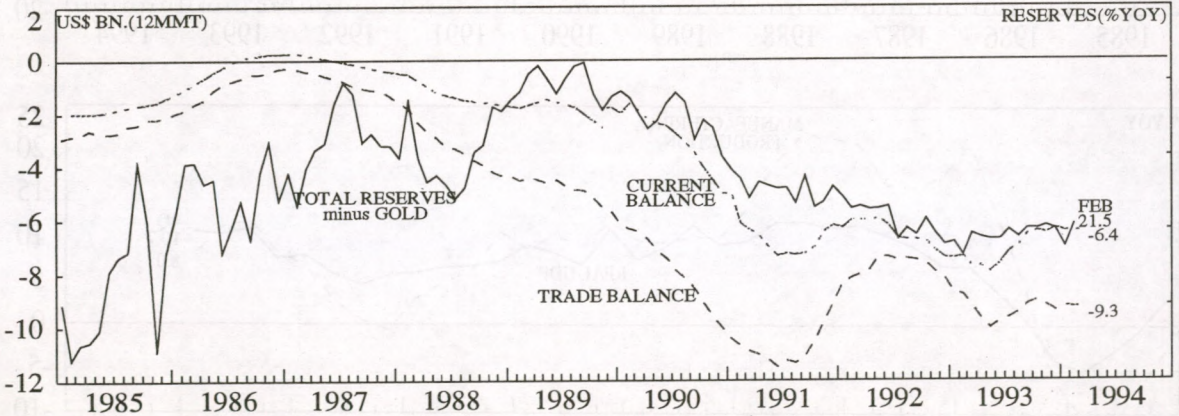
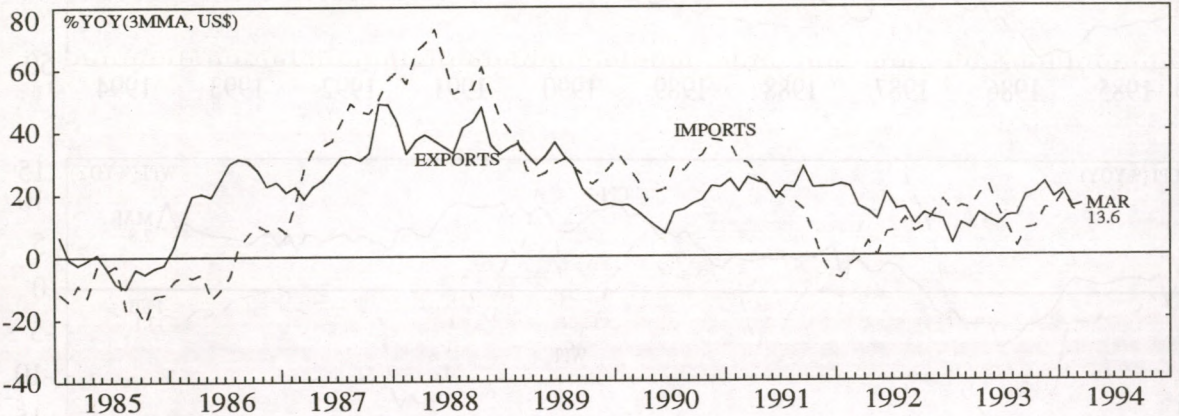
SINGAPORE: MONEY, OUTPUT, GOODS & ASSET PRICES



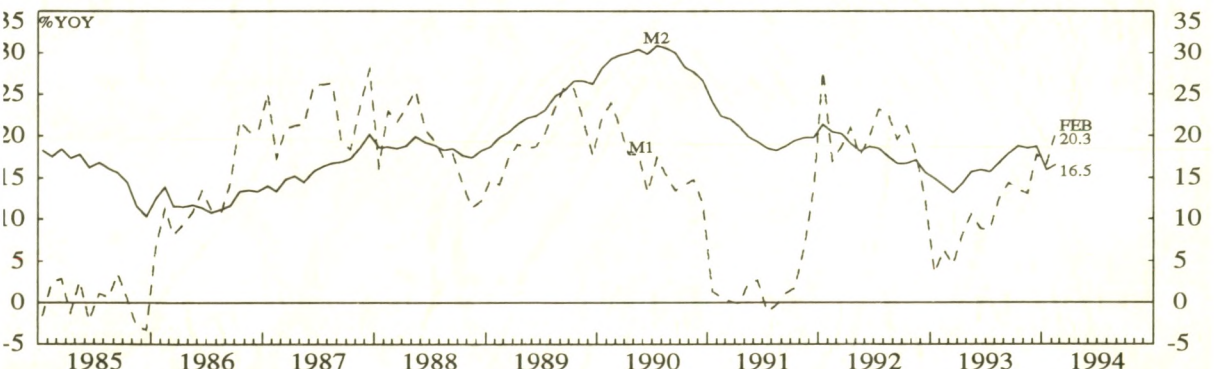
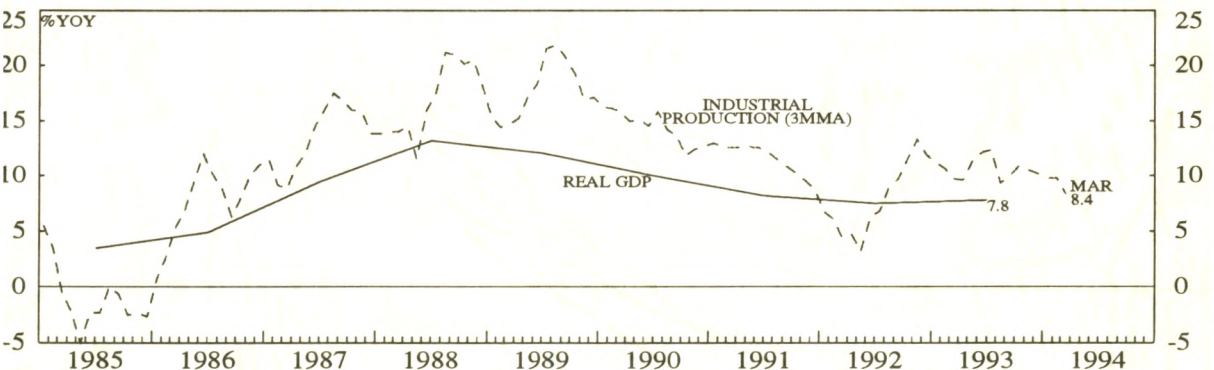
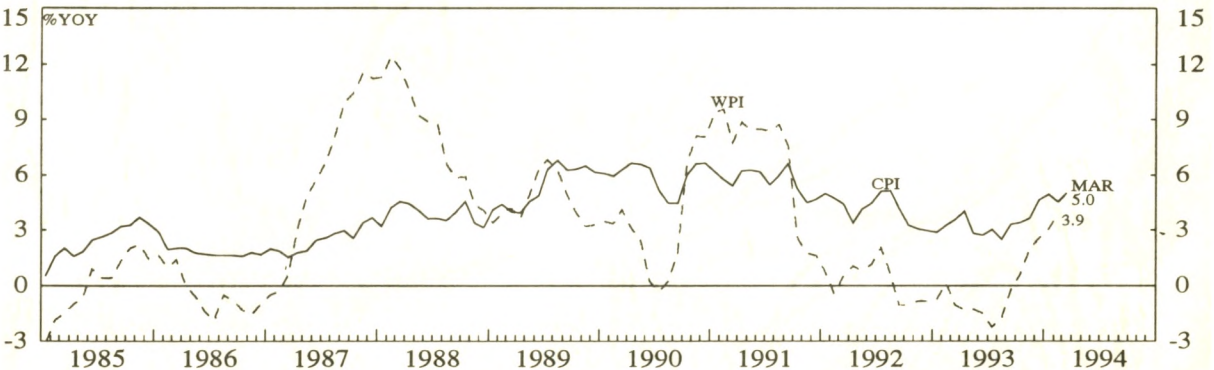
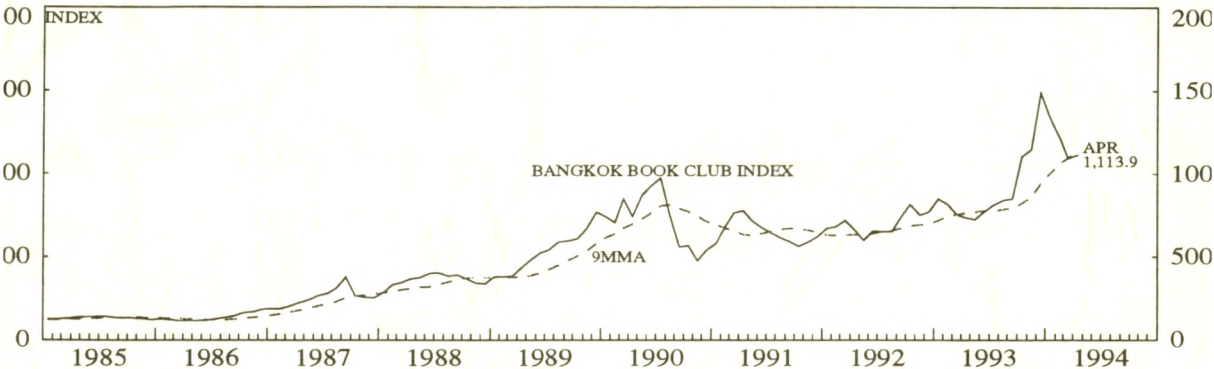
THAILAND: MONETARY TIGHTENING TO FOLLOW RISES IN US RATES

Assuming that the authorities want to keep the exchange rate fixed against a US\$ dominated basket and given the substantial trade and current account deficits, together with recent and likely future increases in US interest rates, a modest tightening of Thai monetary policy appears very likely. This should contain broad money growth at 15-20% and facilitate continued steady GDP growth with inflation remaining in the 4-5% range.

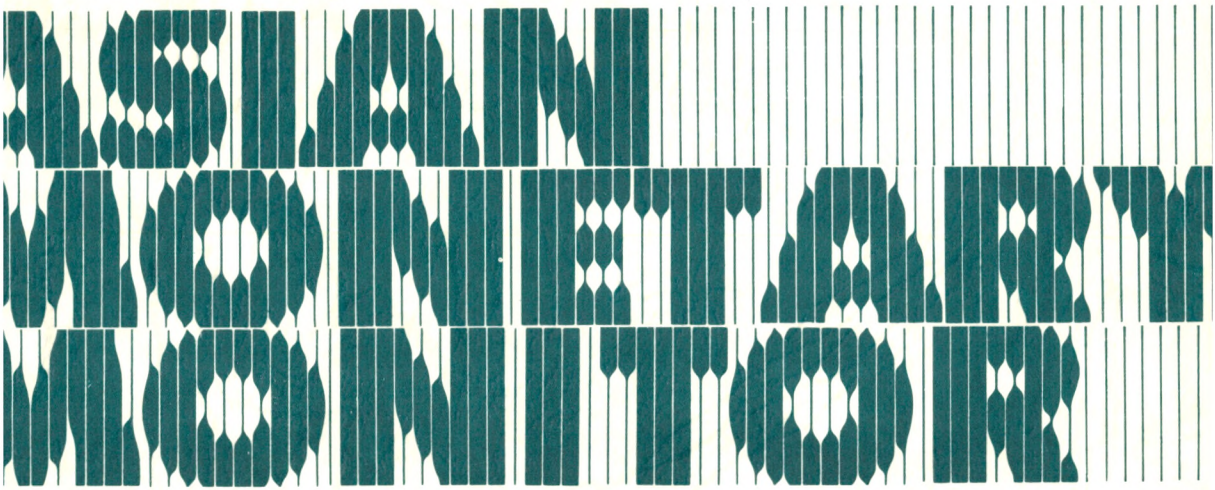
THAILAND: MONEY MARKET AND BALANCE OF PAYMENTS



THAILAND: MONEY, OUTPUT, GOODS & ASSET PRICES







CONTENTS

	Page
AUSTRALIA	
Vigorous Growth Implies Rise in Short-Term Rates by John Greenwood	1
KOREA	
Easy Money Fuels Speedy Recovery by Jakob Lund	11
THAILAND	
Judging the Strength and Length of the Next Economic Cycle by Philip Wyatt	23
ECONOMIC CAPSULES	
China: Tight Economic Policies Have some Effect	JWL / PTW 36
Hong Kong: Rising Real Interest Rates Hits Asset Prices	JWL / PTW 38
Japan: Tentative Signs of Recovery	JWL / PTW 40
Korea: Recovery Gathers Pace	JWL / PTW 42
Taiwan: Awaiting an Export Boom	JWL / PTW 44





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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price US\$300 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to the Editor, Asian Monetary Monitor Ltd., GPO Box 12964, Hong Kong.

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ASIAN MONETARY MONITOR

May-June 1994

Vol. 18 No.3

AUSTRALIA VIGOROUS GROWTH IMPLIES RISE IN SHORT-TERM RATES

Introduction

So far Australia has enjoyed a remarkably low-inflation recovery by comparison with previous recoveries. The critical questions for the next stage of the recovery are (1) how will the composition of demand alter? (2) will wage inflation remain sufficiently restrained not to exert upward pressure on the CPI?, and (3) can long-term interest rates come down even if short rates are raised? This article addresses these issues while providing a general overview of the recovery to date.

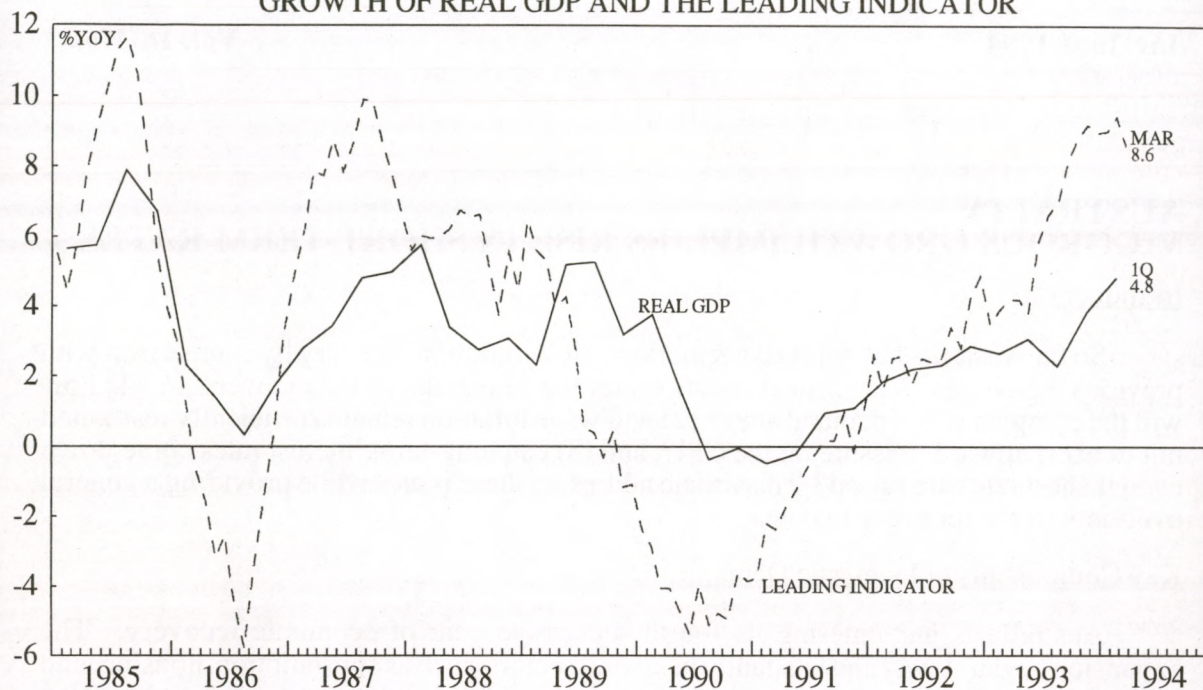
Key Components of Domestic Demand

Australia is just entering its fourth successive year of economic recovery. The expansion began slowly and hesitantly in several sectors, such as consumption, housing, and government spending, while in others such as private business investment there has been almost no upswing at all so far. Nevertheless recent overall growth has been at a strong pace by historic standards, with real GDP accelerating to 4.8% year-on-year in 1994Q1. Moreover, the leading indicator (see Chart 1) suggests that growth will stay very strong in 1994-95. As the recent surge of activity in the more vigorous sectors moderates, the ability of the economy to maintain a strong growth rate will depend very much on the possibility of an upswing in business investment spending. With inflation low, there is little reason to fear any serious monetary tightening by the authorities, so the expansion should be able to continue for the next 2-3 years without threat of premature termination.

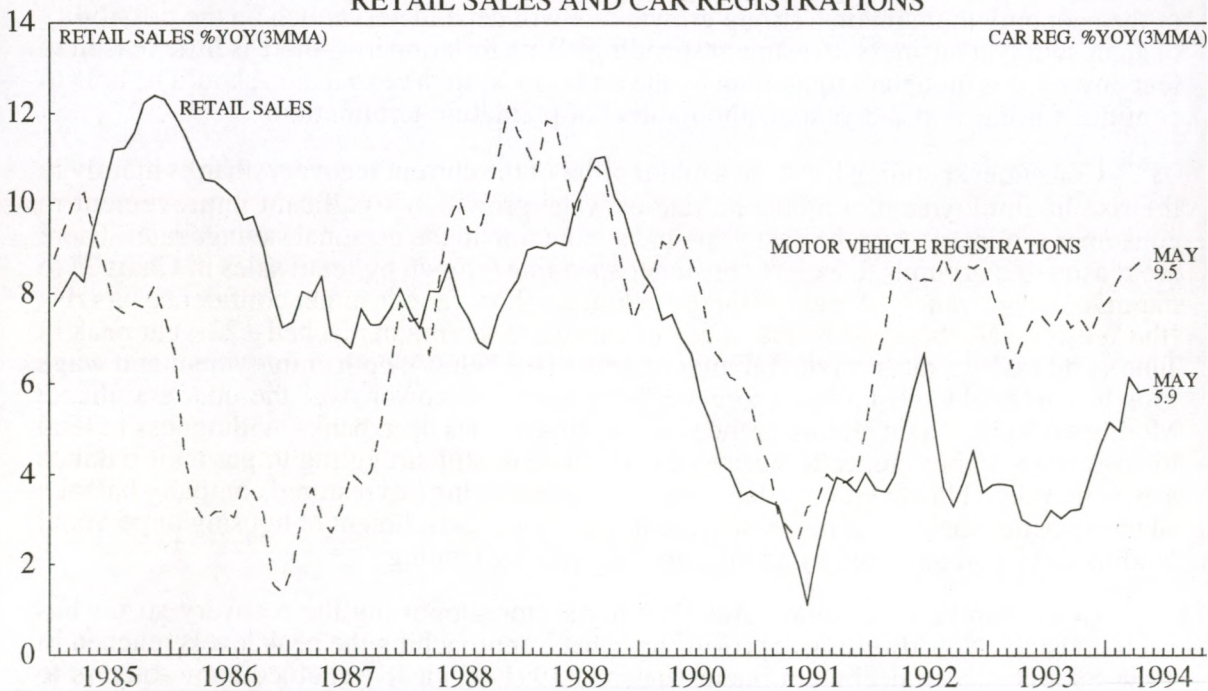
Consumer spending has been a major pillar of the current recovery, thanks mainly to the rise in employment, a moderate rate of wage growth, a significant improvement in consumer sentiment over the past year, and a reduction in the personal savings rate. There are reasonable grounds to expect consumer spending (shown by retail sales in Chart 2) to maintain its buoyancy. Although there are limits to how far consumer confidence can rise (the Westpac-Melbourne Institute index of consumer sentiment reached a 22-year peak in June), and savings rates cannot fall much further (see below), both employment and wage growth could add substantially to underlying spending power over the quarters ahead. Moreover, a prominent feature of the present upswing has been banks' willingness to lend to consumers in preference to businesses which were still struggling to put their balance sheets in order. However, now that corporate restructuring has restored company balance sheets to better shape it seems reasonable to expect any curtailment of housing or personal lending to be compensated by an increase in corporate lending.

In the capital expenditure area the only sector supporting the recovery so far has been housing. New dwelling approvals have been approaching the peak levels reached in 1988-89. The steep decline in interest rates in 1991-92 clearly enabled home-buyers to finance at low rates in 1993 and in the early part of 1994. In addition, household formation

AUSTRALIA: CHART 1
GROWTH OF REAL GDP AND THE LEADING INDICATOR



AUSTRALIA: CHART 2
RETAIL SALES AND CAR REGISTRATIONS



rates are up modestly, although they do not offset the lower rate of inward migration since 1988. The enthusiasm of the banks for financing home mortgages is shown by the big rise in new housing commitments by lenders since 1991 (see Chart 3). The key question is whether there will be another upsurge in both financing commitments and dwelling approvals in 1994-95. In our view there is likely to be some slowdown as corporate borrowers start to crowd out personal borrowers, and as higher short and long-term interest rates push mortgage interest burdens up. In addition, nominal wage growth will be moderate (4 - 5% p.a.) -- in line with overall domestic demand. During the past five years Australia has made considerable progress in moving towards a more flexible, company or industry-based wage bargaining system with less emphasis on centralised wage-setting. This means that productivity improvements will be more accurately reflected in the wage growth of individual sectors, resulting in greater differentiation of wages between sectors. At the corporate level companies are having a tough time setting or holding prices and have only been able to expand their operating margins by small amounts in the past year, mainly by cost-cutting. These same pressures should translate into restrained wage growth, which in turn will hold down new expenditures on housing.

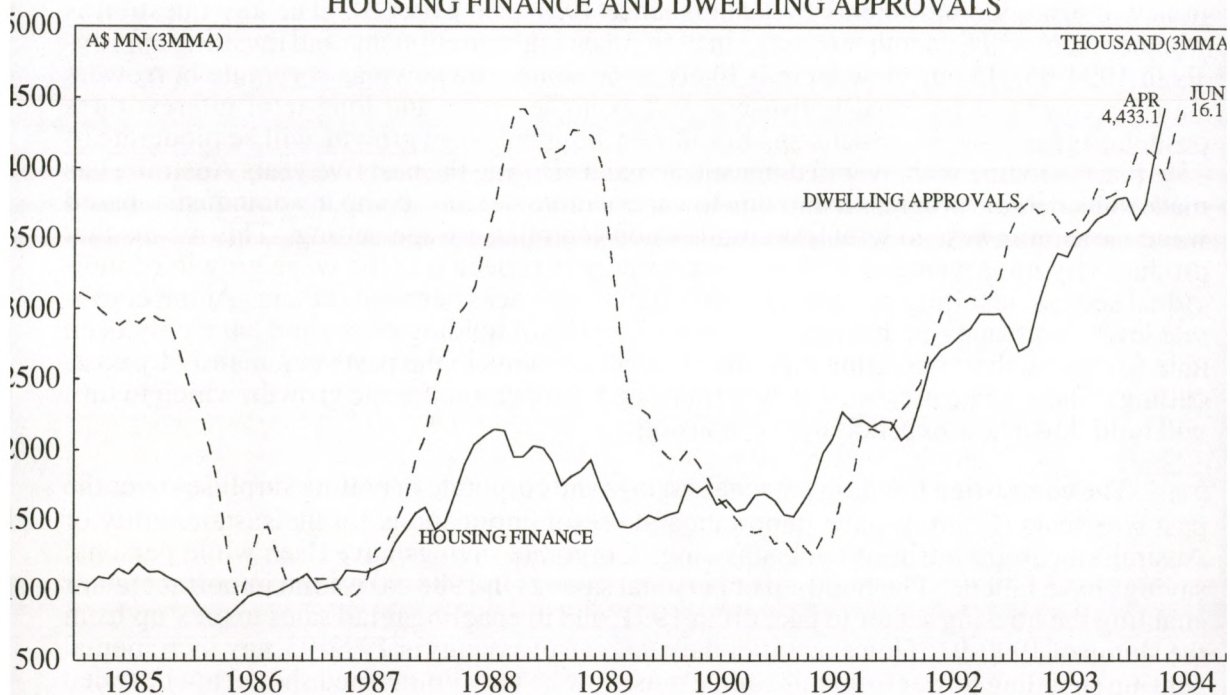
The contrasting trends in personal savings and corporate operating surpluses over the past two years (Chart 4) have important and useful implications for the sustainability of Australia's current business cycle upswing. Corporate savings have risen while personal savings have fallen. The build-up of personal savings in 1988-90 was an important factor enabling the housing sector to take off in 1991, and in enabling retail sales to pick up from the slump of 1990-91. However, after the rundown of savings in 1992-93, any incremental pent-up spending power from this source must now be very limited and should not be relied on for maintaining consumer spending. In the corporate sector, by contrast, the decline in interest rates in 1991-92 enabled net margins to be rebuilt, resulting in higher profits. As domestic demand improves and the expansion broadens, companies can be expected to start increasing their capital expenditure -- initially from internal resources but later from borrowing or new share issues. In short, corporate borrowing should be able to take up the slack as personal borrowing peaks out.

The weakest area of the economy during the present recovery has been corporate fixed capital expenditure as illustrated in Chart 5. Although previous capital spending booms have typically been brief, lasting two years at best, the growth rate in past expansions has far exceeded what has been experienced so far in this cycle. The depth and especially the duration of the 1990-92 downturn is accounted for by the severe overextension of corporate balance sheets in the preceding boom. Several of the largest, most overextended conglomerates have disappeared from the corporate landscape, while the survivors have been busily engaged in cleaning up their balance sheets and lowering their costs. There are now signs that corporate restructuring over the past two or three years is finally starting to pay off in the sense that firms are ready to spend on new investment projects and banks are more eager to lend to corporate customers than they were in the early stages of the upswing. Rising profits, reduced gearing and higher levels of capacity utilisation point to greater capital spending in the next few quarters. A strong upturn in imports of machinery and transport equipment indicate that this upturn may already be under way, led by small businesses.

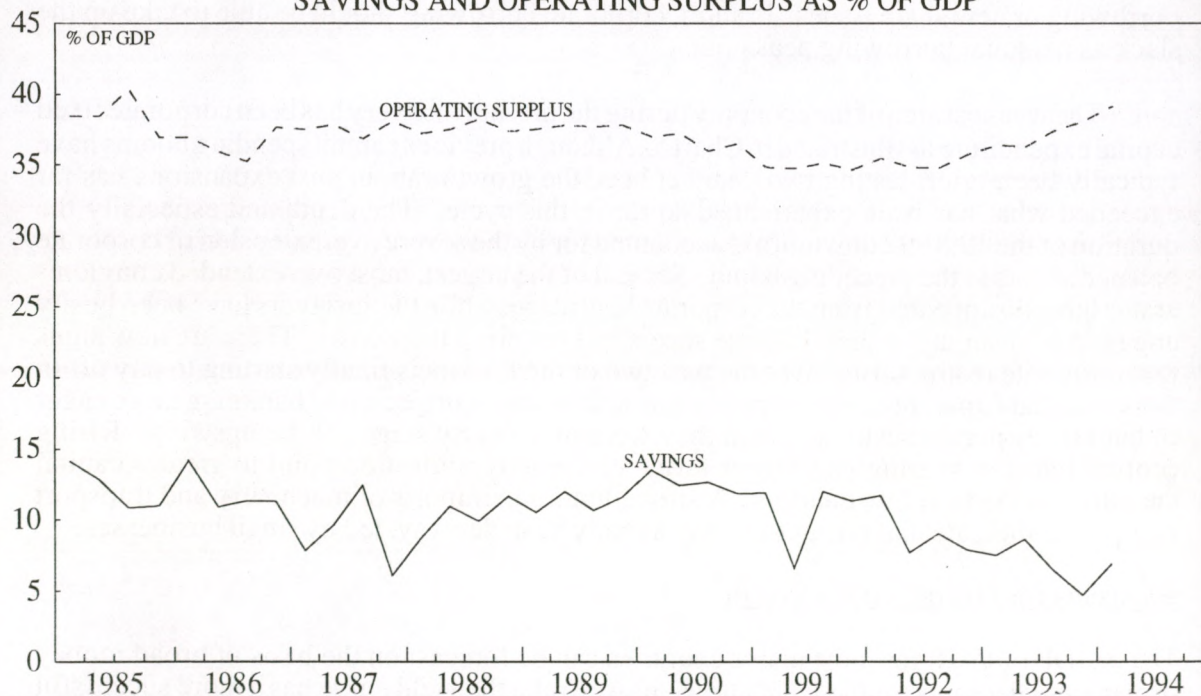
Prospects for Overall GDP Growth

GDP or GNP for most major countries can be forecast on the basis of broad money growth and the shape of the yield curve. In Australia the yield curve has a more successful predictor of GDP than money growth for two reasons. First, the monetary statistics were distorted by the exclusion of bank bills. In the late 1980s bank bills were excluded from the

AUSTRALIA: CHART 3
HOUSING FINANCE AND DWELLING APPROVALS



AUSTRALIA: CHART 4
SAVINGS AND OPERATING SURPLUS AS % OF GDP



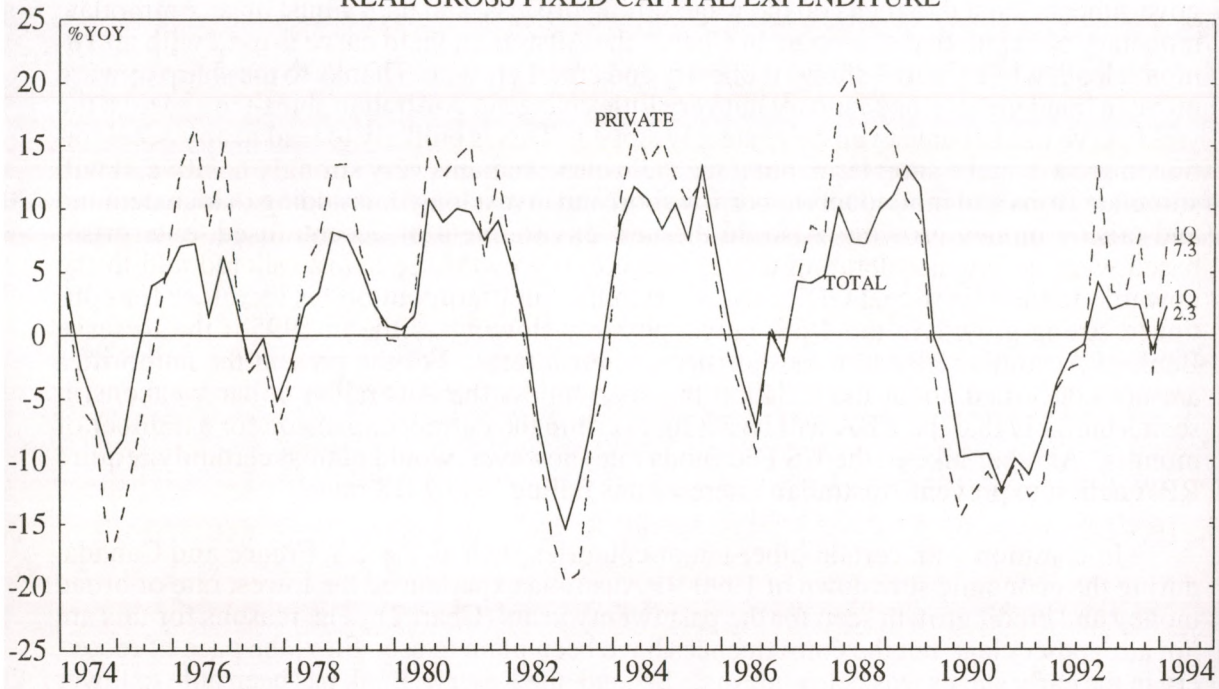
definition of money despite the fact that they grew very rapidly, at one stage accounting for 50% of banks' liabilities. Second, the high degree of centralised wage setting meant that governments tended to focus on the wage setting process, and then adjust or accommodate monetary policy to that outcome. In Chart 6 the Australian yield curve is used with an 18-month lead, while Chart 7 shows monetary and credit growth. Thanks to the sharp upward move in bond yields since January but very little change in Australian short-term yields, the yield curve has become even more steeply sloped. This is unlikely to lead to any acceleration in growth in the short term, but if the yield curve remains very strongly positive, it will stimulate firms and individuals to borrow short and invest long thus adding to loan demand and raising money growth. Also, in the new environment of decentralised, enterprise-based wage setting accelerating money and credit growth (see below) should add to the upward momentum in real GDP. The short to medium-term outlook is therefore for continued strong growth in the 4-6% range, possibly slowing a little in 1995 if the Reserve Bank of Australia (RBA) raises short-term interest rates. For the present the authorities are not concerned about the inflation threat so unless the Australian dollar weakens, it seems unlikely that the RBA will be acting to crimp the current expansion for a number of months. Another hike in the US Fed funds rate, however, would almost certainly require RBA action to prevent Australian interest rates falling below US rates.

In common with certain other major countries such as the US, France and Canada, during the economic slowdown of 1990-91 Australia experienced the lowest rate of broad money and credit growth seen for the past twenty years (Chart 7). The reasons for this are not altogether clear, but the consequences have been plain to see. First, the pace of recovery in the early stages was below normal. Second, the Reserve Bank has been able to lower the short-term cash rate as low as 4.7%. Third, the CPI inflation rate dropped to below 2% in 1991 and has stayed mostly below 2% since then. As mentioned above, in view of past distortions and Australia's past tradition of centralised wage bargaining and wage setting through a series of accords between the government and the unions, and the generally passive role of the Reserve Bank in accommodating the permitted wage growth, the relation between money and GDP in Australia is not as tight as it is in many other developed countries. Therefore, monetary statistics have not always been a reliable guide to economic conditions. Nevertheless, given the deregulatory changes in the labour market in favour of more differentiated sectoral wage setting, the recent gradual upturn in the money and credit aggregates augurs well for an extension of the current economic expansion.

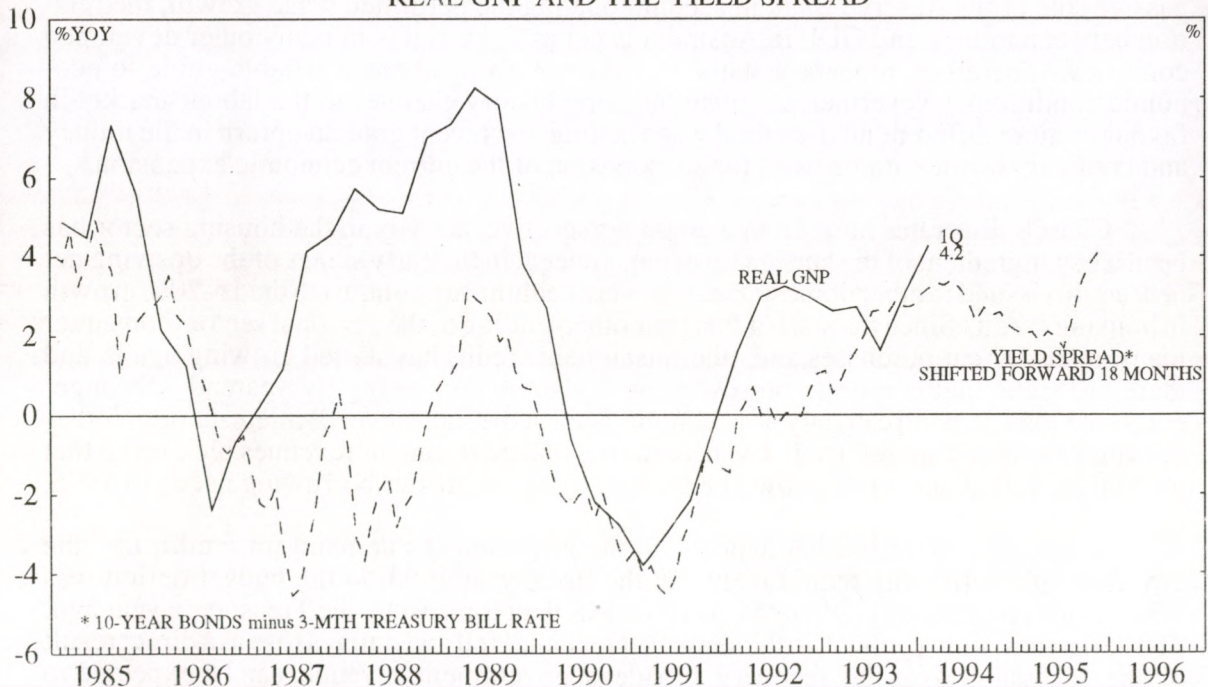
Chart 8 illustrates how, from a credit perspective, activity in the housing sector has been a key ingredient of the current upswing. Indeed, in the early stages of the upswing net new credits issued to other domestic sectors were declining in contrast to the 15-20% growth in housing credit. Since the start of this year other lending to the personal sector (consumer loans, loans for car purchases and other instalment credit) has started growing again, and there are signs that corporate borrowing will also be recovering by yearend. Stronger corporate loan demand can only be accommodated at the same level of interest rates if other demands for funds are reduced. Even assuming that government revenues pick up so that the budget deficit starts to narrow, the prospects are for greater borrowing needs in 1995.

A key issue here is what happens to the government's demand for credit, i.e., the government's borrowing requirement. In the fiscal year 1993-94 the budget deficit was A\$13.6 billion (3.2% of GDP) or \$2.4 billion less than forecast by the Treasurer a year ago. The deficit is mainly cyclical, in the sense that revenues fell and outlays rose as a direct result of the recession, so as the recovery broadens, government revenue can be expected to

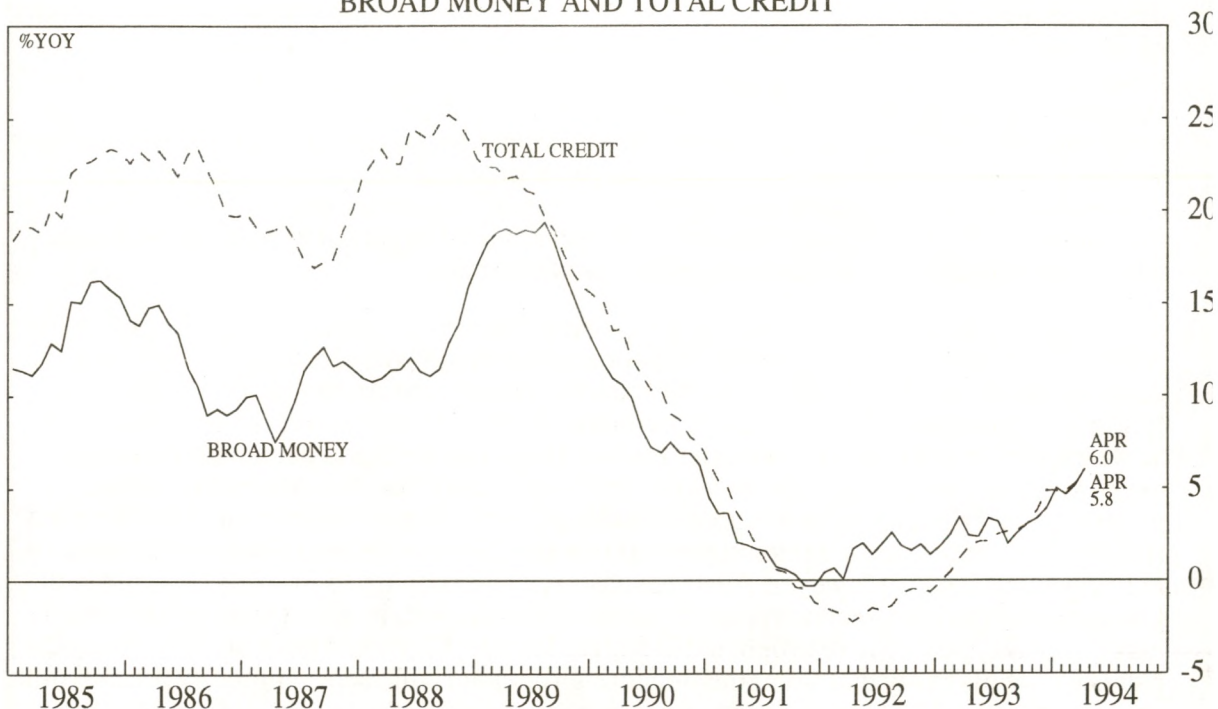
AUSTRALIA: CHART 5
REAL GROSS FIXED CAPITAL EXPENDITURE



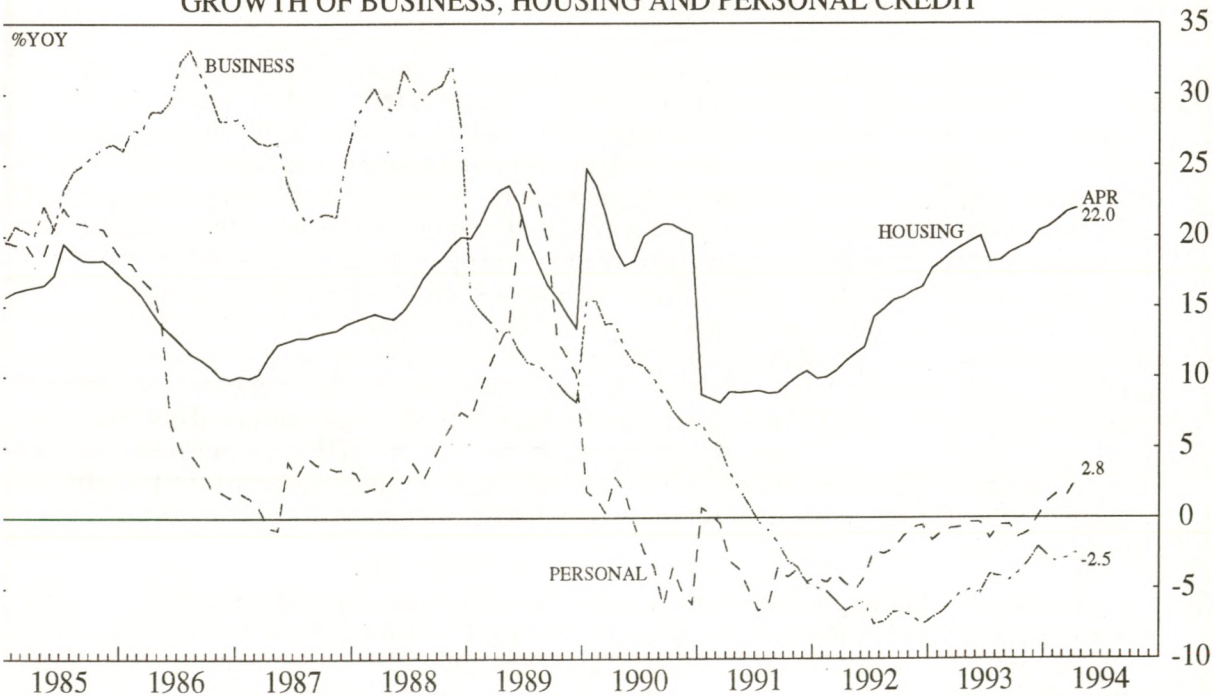
AUSTRALIA: CHART 6
REAL GNP AND THE YIELD SPREAD



AUSTRALIA: CHART 7
BROAD MONEY AND TOTAL CREDIT



AUSTRALIA: CHART 8
GROWTH OF BUSINESS, HOUSING AND PERSONAL CREDIT



increase and the budget deficit will fall. However, compared with past recoveries, revenue will probably not recover as rapidly due to the slow rate of wage growth (and hence personal tax receipts) as well as a decline in non-tax revenue. In the most recent budget the Treasurer announced a scheme called "Working Nation" under which the Commonwealth government committed A\$6.5 billion over four years to employment and training initiatives, industry, science, trade and regional development programmes, together with an income support programme designed to encourage unemployed people to take on full and part-time employment. This package captured the headlines because it reflects the government's sensitivity to unemployment, but it is not large in financial terms on an annual basis. In conclusion, the budget deficit is likely to narrow steadily over the next 2-3 years, which in turn means the borrowing requirements of the government ought not to conflict too abruptly with any reasonable expansion in corporate credit demand.

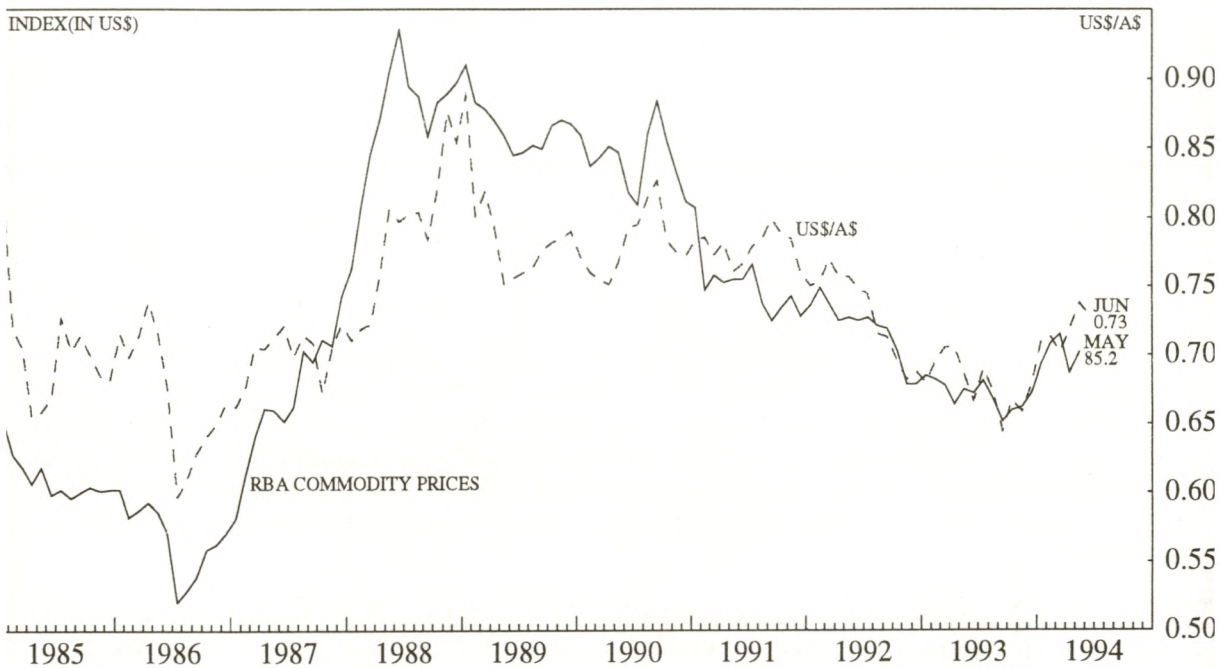
Turning to the external sector, it is first necessary to consider the outlook for the Australian dollar on the assumption that domestic demand will accelerate slowly over the next two years. As shown in Chart 9, the external value of the Australian dollar has closely followed the fortunes of Australia's key commodity export prices over the past decade. If, as we expect, major OECD economies recover further in 1995 and demand for Australia's main exports, especially coal, iron ore and wool improves, the Australian balance of payments can be expected to strengthen, leading to some appreciation in the A\$. The main risks to this scenario are a tightening of credit in the US and a failure of economic recovery in Europe and Japan. However, Australia has been diversifying its markets away from the UK and other European economies in favour of Asian markets in recent years, which should make the A\$ more sensitive to demand in Korea, Taiwan, China and the ASEAN region. On balance it seems likely that strengthening foreign demand will keep commodity prices firm, ensuring that the A\$ also remains strong on a trade-weighted basis. The only serious threat to the A\$ would come from an excessively easy domestic monetary policy (e.g., if short-term interest rates were held down too long and/or money and credit growth were permitted to rise to the mid-teens or higher). In the absence of such domestic policy mistakes the prospects are for a firm A\$ through 1994 and 1995.

Looking at the components of the balance of payments, the deterioration in the trade and current balance in the past two or three years (Chart 10) reflects the relatively stronger recovery of the Australian economy than some of its trading partners. Typically imports pick up faster than exports during a consumer-led recovery in Australia, and later the early stages of a capital spending boom leads to a big increase in imports of machinery and transport equipment which Australia does not produce itself. The large gap between the trade account and the current account deficit is due mainly to interest payments on outstanding overseas debt -- a debt which can only be paid down if Australia is able to run a current account surplus, which in turn would require a solid trade surplus. Meanwhile current account deficits on the present scale are entirely sustainable and should not blow out to unfinanciable levels as long as credit growth remains fairly subdued. In recent years Australia's net external debt has stabilised at 41-42% of GDP, and an increasing share of the foreign capital inflow has gone into equity investments -- now amounting to about 18% of GDP. On an international comparative basis, therefore, Australia's overall external liabilities position is improving, as reflected in the decline in net debt servicing from 20% of exports in 1990 to about 11% of exports in 1994.

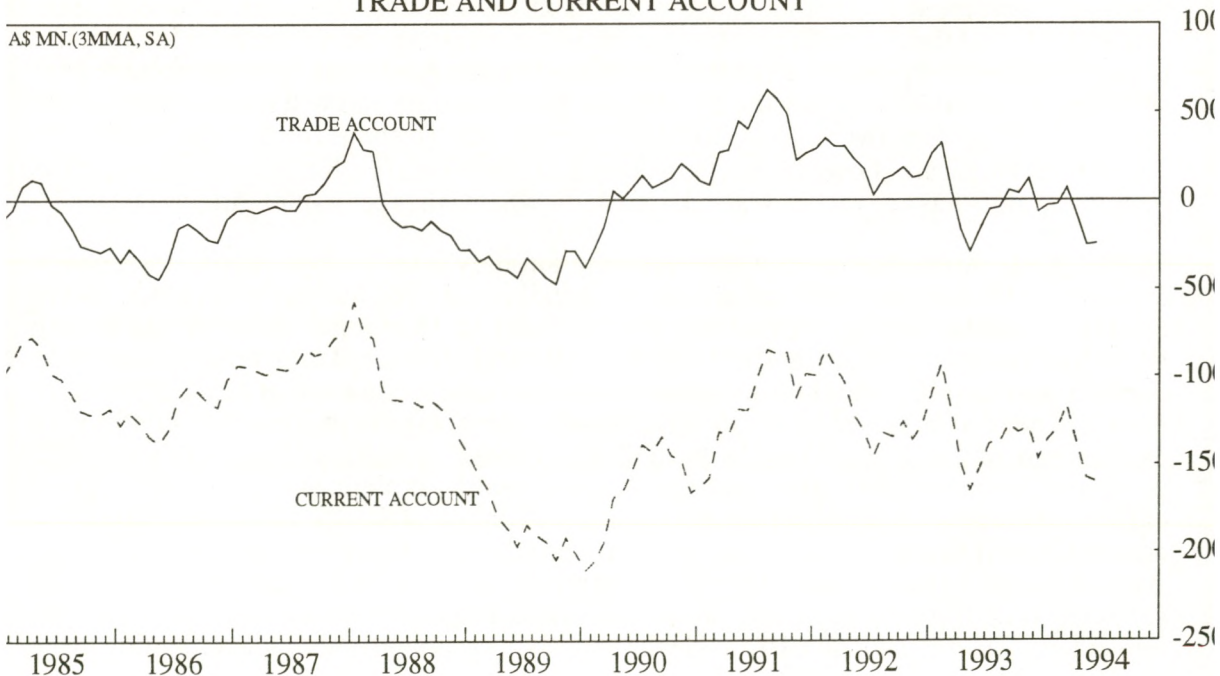
Gradually, this improvement in Australia's external indebtedness should start to be recognised in the market and reflected in the lowering of the risk premium on Australian debt. Sadly, the improvement over the past three years was not acknowledged during the sell-off between February and May of this year as Australian yields rose more steeply than yields in almost any other OECD country. This probably reflects the continuing poor perception among international bond investors of the Australian constitutional arrangements whereby

May-June 1994

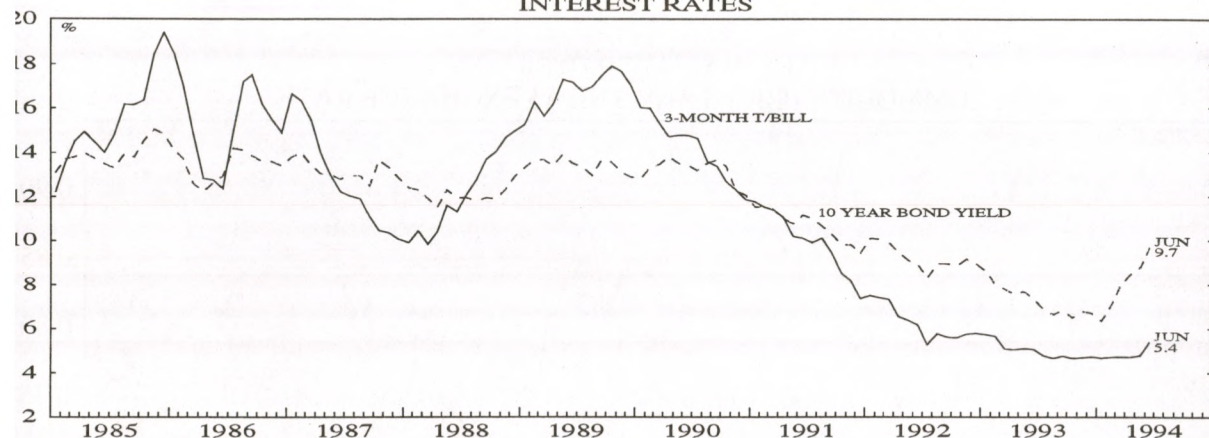
AUSTRALIA: CHART 9
RBA COMMODITY PRICES AND THE A\$ EXCHANGE RATE



AUSTRALIA: CHART 10
TRADE AND CURRENT ACCOUNT



AUSTRALIA: CHART 11
INTEREST RATES



(a) general elections must be held every three years -- which is perceived to give the Australian government a rather short-term orientation in financial policy matters (i.e., quick fixes prevailing over serious long-term structural solutions) -- and (b) the undoubted disparity which has now opened up between New Zealand with its independent Central Bank operating under a mandate to secure the single goal of 0-2% inflation, and Australia with its Central Bank still very much an instrument of the Treasury and hence of cabinet policy directives.

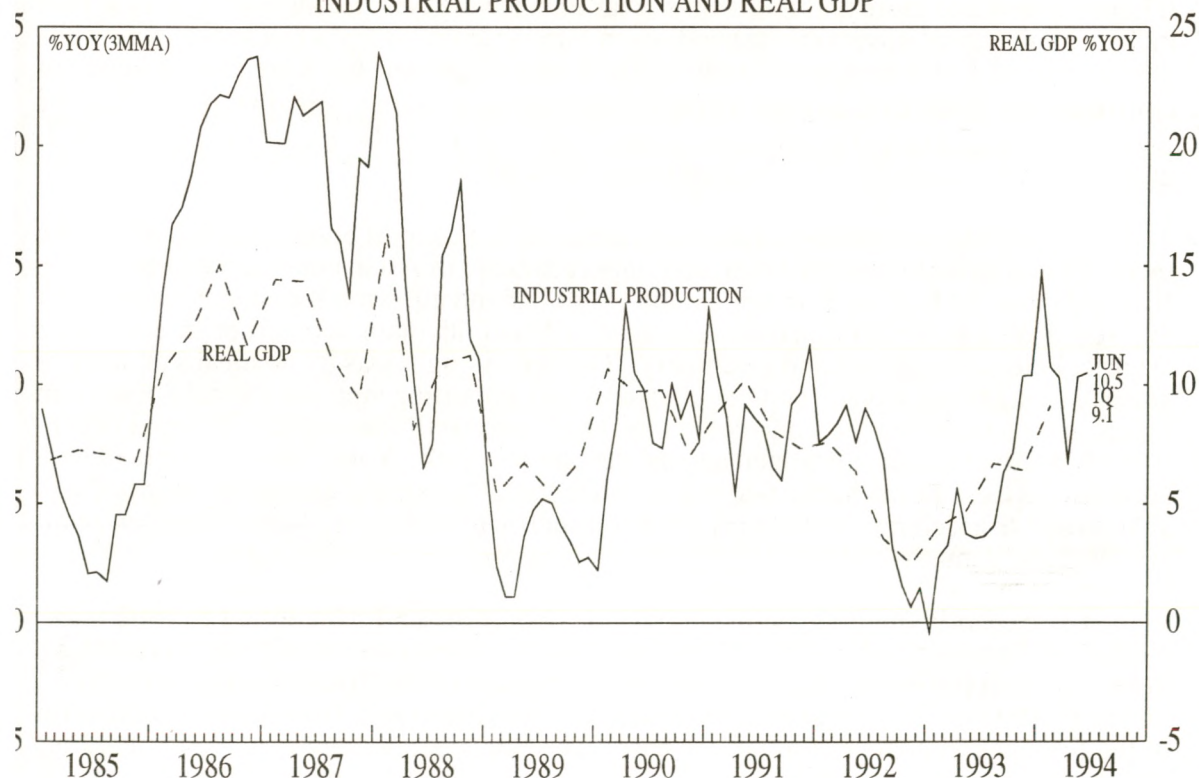
With Australian 10-year government bonds yielding over 9.5% (at the time of writing) versus CPI inflation of 1.8%, the real yield is an attractive 7.7%. The big sell-off in Australian bonds seems overdone both in relation to inflation prospects in Australia, in relation to the improvement in Australia's external net indebtedness since 1990, and in relation to any conceivable short-run increase in credit demands. However, the large positive yield spread of 400 basis points (Chart 11) will almost certainly encourage corporate borrowers (among others) to borrow short-term funds and invest in higher yielding long-term projects or financial instruments. At some stage in the next 6-9 months, therefore, it would seem unavoidable that the Australian authorities should start raising short-term rates in order not to permit a credit explosion. Like the Fed in the US, the Australian authorities have kept short-term rates unusually low for a prolonged period of time and will need to prevent the consequences spilling over into an over-heating economy. (It should be noted that although T-Bill rates which are shown in the chart have risen, the official cash rate -- equivalent to the Fed funds rate -- has not yet been raised from 4.7% where it has been since August last year.)

FORECAST: Australia's economy is growing strongly after a slow start to the current expansion. Housing demand and consumer spending have led the recovery, but a shift to capital expenditure-led growth is likely over the next 12-18 months. Bond yields, having risen sharply since February, are probably too high in relation to inflation prospects or credit demand, and therefore should come down somewhat in the second half of 1994. Short-term rates will need to be raised by the Reserve Bank at some stage in the next 6-9 months if an explosion in credit demand is to be headed off. The A\$ should stay firm as other OECD economies recover and Asian economies enjoy healthy growth, since both will support commodity prices which are in turn important determinants of the A\$. The on-going current account deficit should not pose any financing problem. Although in the past three years Australia's net external indebtedness has improved in relation to GDP and its net debt servicing ratio (interest payments on net external debt as a percentage of exports), in the longer term Australia will need to tackle the underlying problem of its poor perception in the market, either by dramatically and permanently lowering its inflation prospects, or by revising its constitutional arrangements regarding the permitted term of each administration and/or the independence and mandate of its Central Bank.

KOREA EASY MONEY FUELS SPEEDY RECOVERY

Although overshadowed in recent months by political developments, Korea's economy has experienced a more rapid and impressive recovery from the down-turn in 1992 than expected by most observers -- including the Korean authorities. There are undeniably several structural reasons for the resilience of Korea's economy: a highly skilled workforce, a switch from labour-intensive to capital- and technology-intensive industries, high savings and investment rates, etc. However, the pace of the recent recovery has also been stimulated by a loose stance of monetary and fiscal policy, motivated by unjustified fears of the economy's vulnerability to dislocations resulting from relatively modest structural reforms and by a very belated official recognition of the strength of the recovery. Moreover, the process of economic liberalisation has diminished the authorities' ability to supplement monetary and (ostensibly balanced) fiscal policy with interventionist industrial policy (such as direction of bank credit to priority sectors, price controls, and other forms of administrative guidance). But the liberalisation process, and the intended transformation of the monetary transmission mechanism so official interest rates can be used to influence aggregate demand, is still by no means complete, but has progressed sufficiently to make the impact of monetary policy that much more difficult for the authorities to predict. This article will provide an overview of economic developments and financial reform measures since our last article on South Korea (AMM, March-April 1993), and asks whether the present monetary policy framework of targeting M2 and stabilising the dollar-won exchange rate is appropriate and sufficient for managing Korea's now more liberalised economy.

S. KOREA: CHART 1
INDUSTRIAL PRODUCTION AND REAL GDP



Recent Economic Developments

When Kim Young-Sam became President in early 1993, most observers saw only doom and gloom on Korea's economy. GDP growth had slowed from double-digit growth during much of the late 1980s to just 2.8% in 1992 Q4, and growth in industrial production was negative for a few months. Export growth, long recognised as the main engine for Korea's previously impressive growth, had fallen into negative figures for a number of reasons: sluggish external demand, loss of competitiveness due to rapid wage-inflation, shortages of inputs because of the authorities' campaign against consumption/imports, and earlier under-investment in plant and machinery as investment had been sucked into the property boom. The incoming administration had only stated its economic policy intentions in vague terms during the election campaign, apart from taking a strong stand against corruption, and the resulting political uncertainty was having a dampening effect on business sentiment.

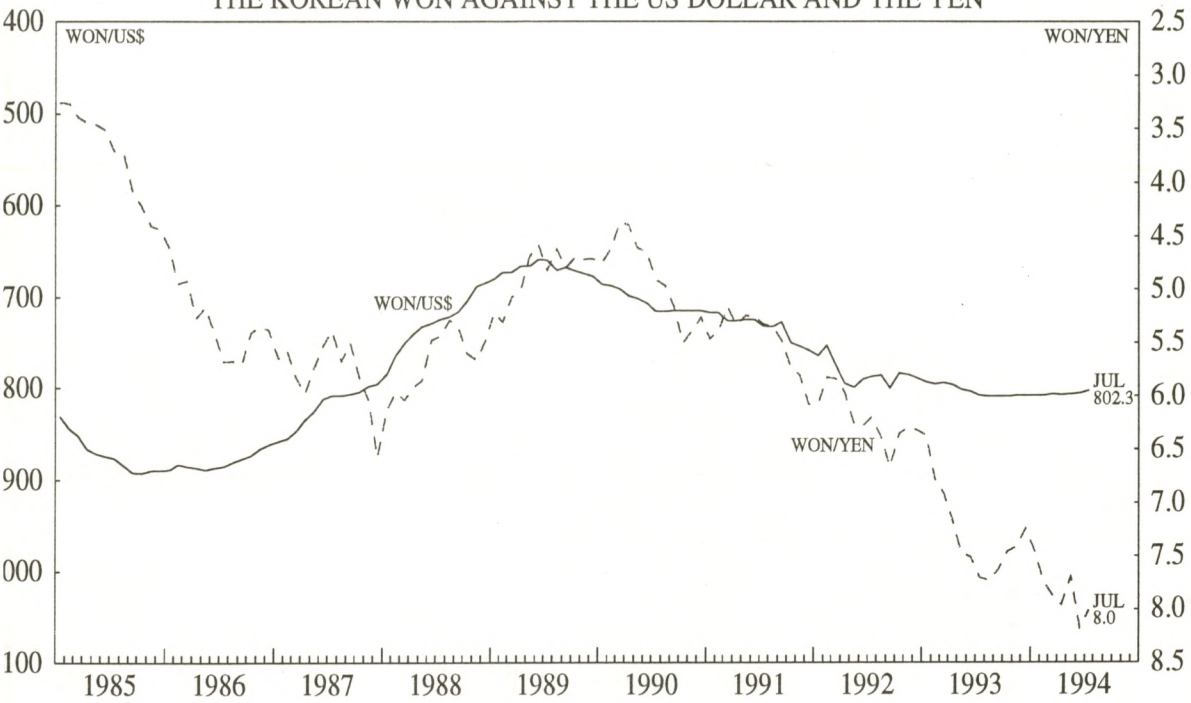
Once in office, the new administration adopted very expansionary economic policies from an early stage. Interest rates were cut within weeks of the change of government, apparently in spite of strong opposition from BoK Governor Cho Soon (who subsequently resigned). Fiscal policy was also switched into a more stimulative mode. Although constitutionally the budget has to be balanced (by a somewhat circumventable definition), planned government spending for 1993/94 was simply front-loaded in the hope of kick-starting the economy and generating stronger tax revenues later in the year. Constraints imposed by the previous administration on imports of capital goods and materials for export production were eased in order to stimulate exports and investment in plant and equipment. The Economic Planning Board was asked to rewrite the economic plan, and in early July 1993 it issued a new and more ambitious Five-Year Plan for the New Economy. The new plan included substantial government spending on infrastructure projects (including a new airport for Seoul and a high-speed railway) and encouragement for Korean companies to continue the shift into higher value-added manufacturing and the relocation of lower value-added manufacturing elsewhere in the region. It also included revised schedules for planned financial liberalisation measures (see below).

The external environment was also conducive to an export boom. The US economic recovery was gathering momentum, and import demand in Asian countries was booming. By stabilising the Korean won against the US dollar and allowing it to depreciate against the Yen, Korea gained competitiveness against Japan, its main competitor in exports of electrical/electronic goods and machinery. The yen-strength was by no means an unmitigated blessing for all Korean companies; some were importing inputs or capital goods from Japan, and some (often the same companies) had borrowed substantially in yen at deceptively low interest rates, unhedged against the currency risk. Nonetheless, combined with domestic factors, the exchange rate policy and favourable external environment stimulated an impressive acceleration in export growth from 0% to 15% (yoy, 3mma) between January 1993 and January 1994.

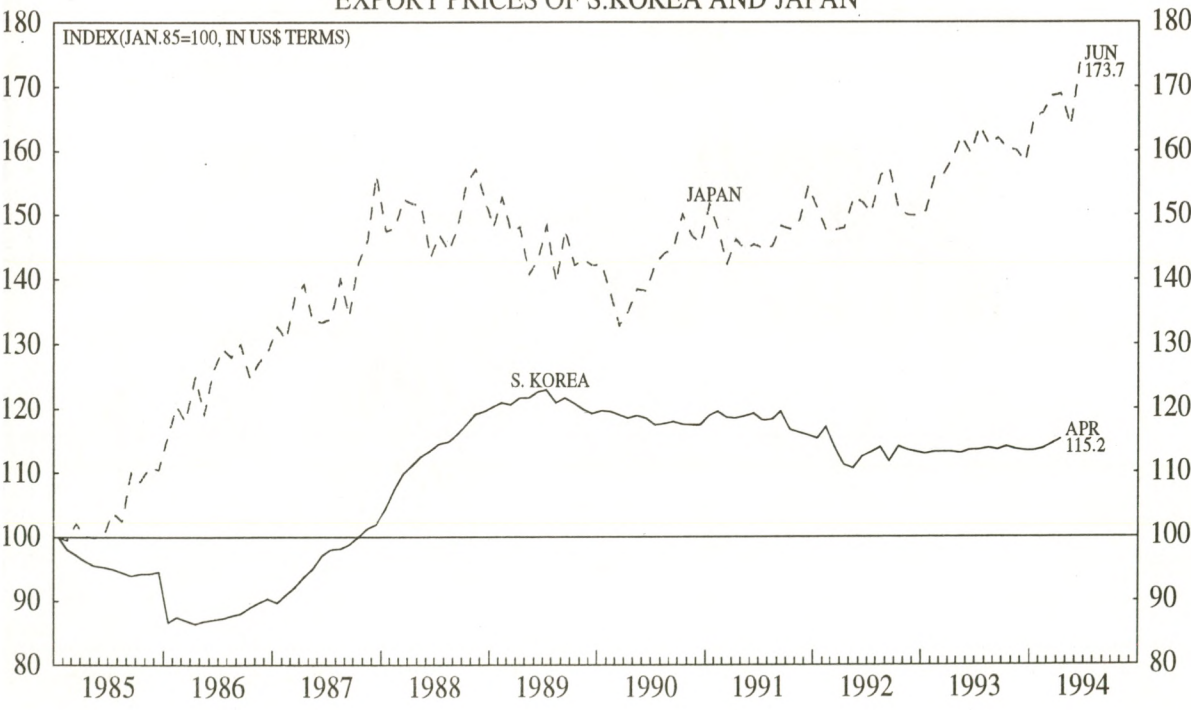
The export boom dragged the current account from a \$4.5 bn deficit in 1992 into a modest \$0.5 bn surplus for 1993. Combined with increased inflows of foreign investment in excess of capital outflows, this resulted in an increase in the official reserves from \$17.1 bn at end-1992 to \$20.2 bn at end-1993, or a 21.1% expansion in Won-denominated terms of the foreign component of monetary base. The BoK operated in the market to contract the domestic component of monetary base to partially offset this monetary expansion. By constraining bank loan growth the BoK was quite successful in keeping M2 growth below 20% in the first half of 1993.

May-June 1994

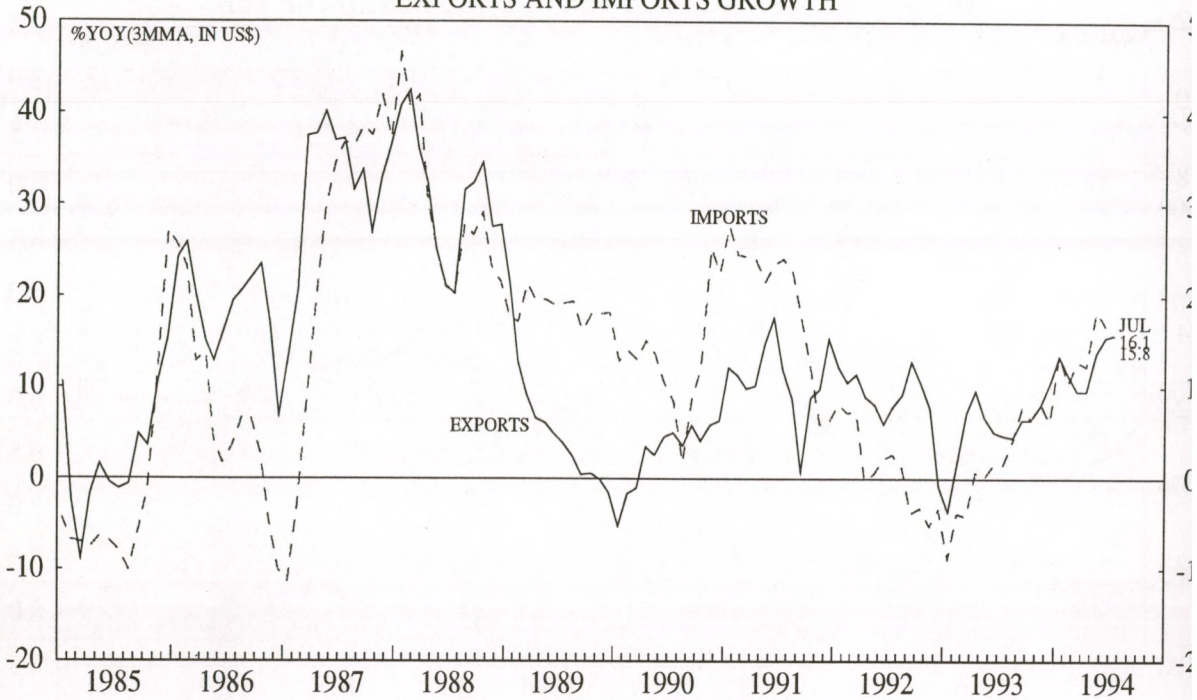
S. KOREA: CHART 2
THE KOREAN WON AGAINST THE US DOLLAR AND THE YEN



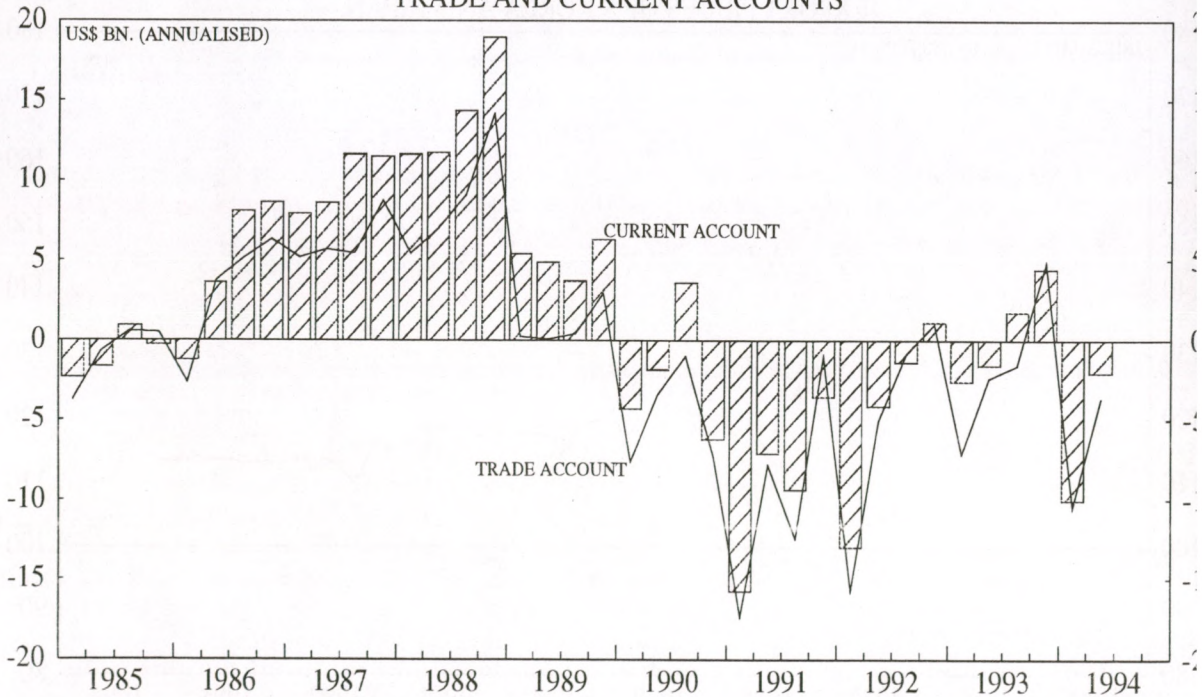
S. KOREA: CHART 3
EXPORT PRICES OF S.KOREA AND JAPAN



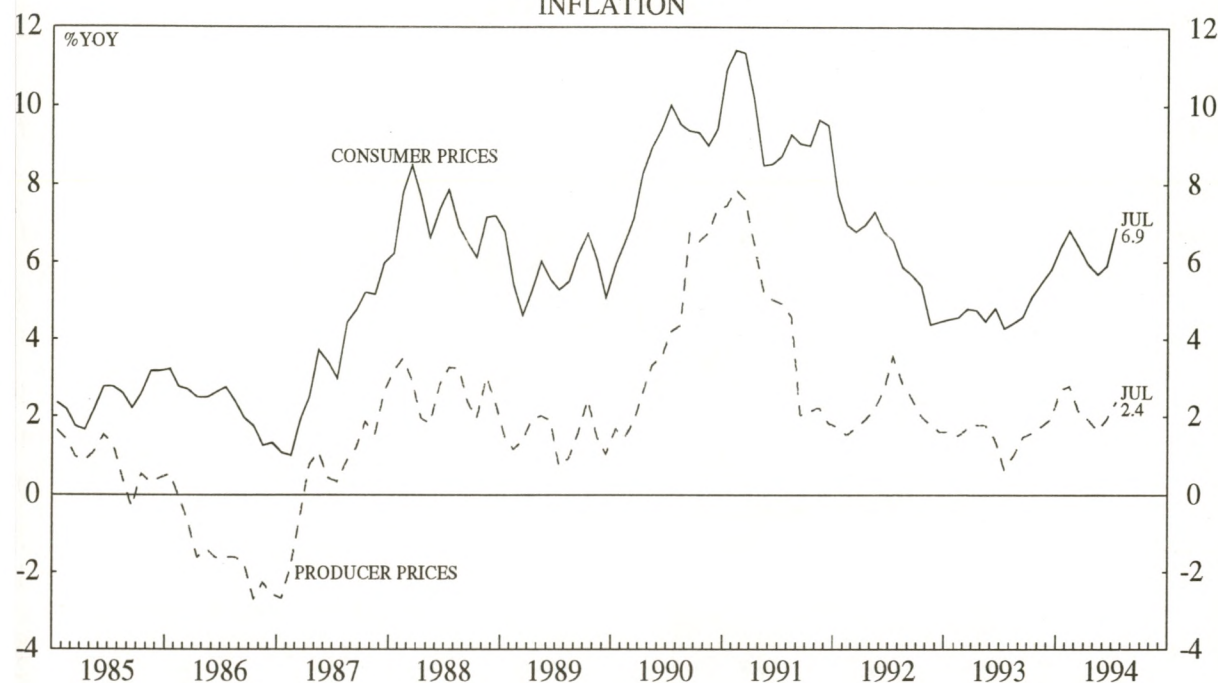
S. KOREA: CHART 4
EXPORTS AND IMPORTS GROWTH



S. KOREA: CHART 5
TRADE AND CURRENT ACCOUNTS



S. KOREA: CHART 6
INFLATION

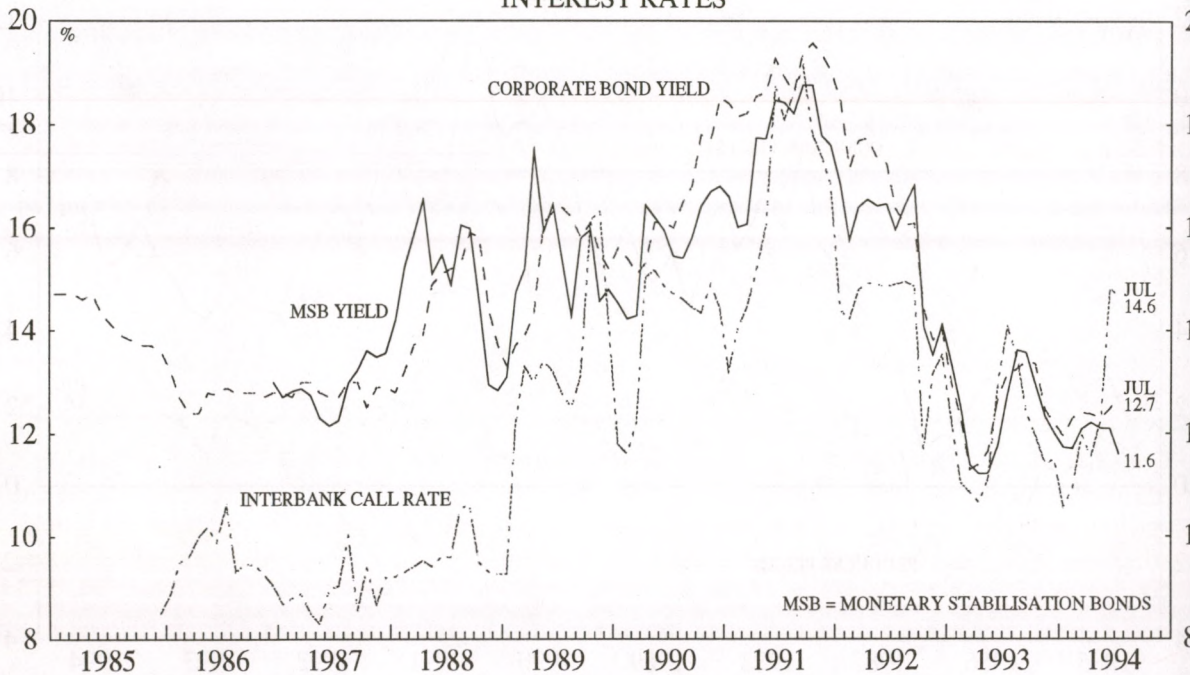


In August President Kim Young-Sam took the country by surprise when he fulfilled his election pledge to introduce the real-name system for financial transactions. The BoK was forced to relax monetary targeting out of fear that the recovery might be derailed by rapidly rising interest rates and nervousness among businessmen over the safety of their assets. Retrospectively, it is clear that the introduction of the real-name system had far less of a negative economic impact than feared at the time, as various amnesty clauses served to buoy up the stock-market and the banking system after the initial shock. The export and investment booms continued unabated, the BoK brought M2 growth back down to 15% by end-1993, and interest rates resumed a downward trend as the episode blew over.

Inflation started to rear its ugly head towards the end of 1993. Consumer Price inflation accelerated from a trough of 4.4% in August to 6.4% in January, while producer price inflation went from 1.0% to 2.7% in the same time period. These high January inflation rates were dismissed as resulting from comparison with a low base a year earlier, and were regarded as acceptable during an economic recovery. The main concern of policy was with sustaining the pace of economic recovery rather than checking incipient inflationary pressures. Inflation did indeed fall back slightly in the following months, but the latest figures show that CPI inflation ticked up to 6.9% in July -- though this was mostly due to erratic food prices.

This latest tick-up in headline CPI inflation, along with acceleration in loan demand and in M2 and probably quite buoyant Q2 GDP figures in the pipeline, appears to have worried the BoK. In early August the BoK adopted a much less accommodating stance of monetary policy, reminding banks of their need to meet statutory reserve requirements, and warning them that any shortfall in reserves would accrue a very penal rate of interest.

S. KOREA: CHART 7
INTEREST RATES



As banks scrambled for funds to meet their reserve requirements interest rates rose on all instruments and maturities. The overnight interbank call rate got pushed up from 15.7% at end-July to 25% on August 4 and 5, and again to 38% on August 8. Banks also tried to raise funds through issuance of CDs, but general lack of investor interest pushed CD rates up from around 13% at end-July to 14.5% on August 8. The yield on Monetary Stabilisation Bonds (MSBs), the banks' main instrument for obtaining liquidity from the BoK remained stable at 12.2%.

If the BoK's intention was to assure investors and bankers that it was prepared to take whatever measures necessary to quell inflation, this was by no means an unmitigated triumph of monetary management. Yields on 3-year corporate bonds (the longest liquid maturity) rose from 12.7% at end-July to 13.35% on 8 August, implying a rise in medium-term nominal interest rate expectations and probably in inflationary expectations as well. There is a not wholly unreasonable assumption in the market that the government's main priority is to sustain the recovery in economic growth, and that in standoffs between the MoF and the BoK the MoF nearly always wins. The conclusion from these assumptions is that the tightening in early August is merely short-term anti-inflation policy posturing by the BoK, and that if it is seen to threaten the pace of economic recovery the MoF will tell the BoK in no uncertain terms to back off.

Recent Financial Liberalisation Measures

The process of financial sector reform in Korea has been aimed at "improving the efficiency of the financial market through phasing out financial regulations and reshaping the financial structure [and] internationalisation of the domestic financial industry" (Research Department, Bank of Korea: Financial Liberalisation and Internationalization in Korea. Seoul: BoK, 1994, p37 -- a useful source for details of financial liberalisation). The May-June 1994

pace of this process has, however, varied greatly over time. In the 1980s financial sector reform was a piecemeal and experimental process, but in 1992 the Roh Taewoo government announced two overall blueprints of financial deregulation and market opening, which were revised further by the new Kim Young-Sam administration in July 1993. The modest acceleration in the pace of financial reform came about partly because of a recognition by the government of the need for wholesale reform to develop a financial system capable of more efficiently mobilising savings and allocating investments for Korea's increasingly complex economy. Another reason has been external pressures in bilateral talks with the US and the EU, and in multilateral talks with GATT and OECD (Korea hopes to become an OECD member by 1996). Korea may even have been delaying liberalisation measures which would have been in its own interest in order to use them as bargaining chips in international negotiations.

From the point of view of improving the efficiency of the financial system and transforming the monetary transmission mechanism to a more market-based one, the most important parts of the financial reform process have undoubtedly been the deregulation of interest rates and bank lending policies. Interest rate deregulation has been a long and cautious process (see box). At this juncture, virtually all lending rates (except those on policy-related loans) have been liberalised, but deposit rates are still tightly regulated. Nonetheless, anecdotal evidence suggests that BoK still exercises suasion on local banks' lending rates, including interbank lending rates charged to foreign banks. Of course, interest rates can only serve as an effective price mechanism if banks are free to make their own commercially motivated lending decisions. The authorities plan to transfer all policy loans to state-owned specialised banks, and to gradually liberalise the restrictions on lending to the 30 largest companies and the requirements for lending to small and medium-sized enterprises. A big question is how quickly Korea's banks, previously used to being told how much to lend to whom at which interest rates, can adapt to their new roles as efficient financial intermediaries.

Chronology of interest rate deregulation

1981	Commercial Paper rates liberalised
1982	Corporate bond yields allowed to fluctuate within +/- 1% of prime lending rates
1984	Lending rates changed from specific rates to bands of permissible rates
1986	Issue rates on corporate bonds, other debt paper and CDs liberalised
1988	Broad interest rate liberalisation
1989	De-facto reversal of 1988 package following a deterioration in economy
Aug. 1991	New four-stage interest rate deregulation plan announced
Nov. 1991	First stage implemented, deregulating discount rates on bills and commercial paper, rates on overdrafts and overdue loans, corporate bond yields (with maturity of over 2 years), and long-term (maturity over 3 years) time deposit rates.
July 1993	Four-stage plan revised by Kim Young-Sam government
Dec. 1993	Second stage implemented, liberalising lending rates on all bank loans not refinanced through the BoK, 2 year deposit rates, short-term corporate bond yields and Monetary Stabilisation Bond yields.
1994-96	Third stage, liberalising rates on BoK refinanced loans, most marketable instruments, and all deposits except demand deposits.
1997	Fourth Stage, setting up plan for deregulation of demand deposit and marketable instruments.

Some progress has also been made in other areas of financial liberalisation over the past year, such as permission for banks to set their own dividends and setting up committees to appoint commercial bank chiefs (previously done by MoF and BoK). Further planned liberalisation measures look almost certain to be implemented, possibly even slightly ahead of schedule, for both domestic and external reasons. Domestically, the authorities realise that future growth potential hinges upon efficiency gains which are more likely to be achieved in a more liberalised environment. On the external side, Korea's export-led growth strategy is dependent on market access. Korea has made commitments to further liberalisation within the GATT Uruguay Round, and also needs to strengthen its application for OECD membership with more market opening before the self-imposed deadline of 1996. The process of international negotiations might be a drawn-out negotiating game where bargaining chips are not conceded lightly (not even if in Korea's own economic self-interest) until the last minute. Thus the liberalisation process may appear to be on ice for years before resuming at speed when there is a breakthrough in OECD membership negotiations.

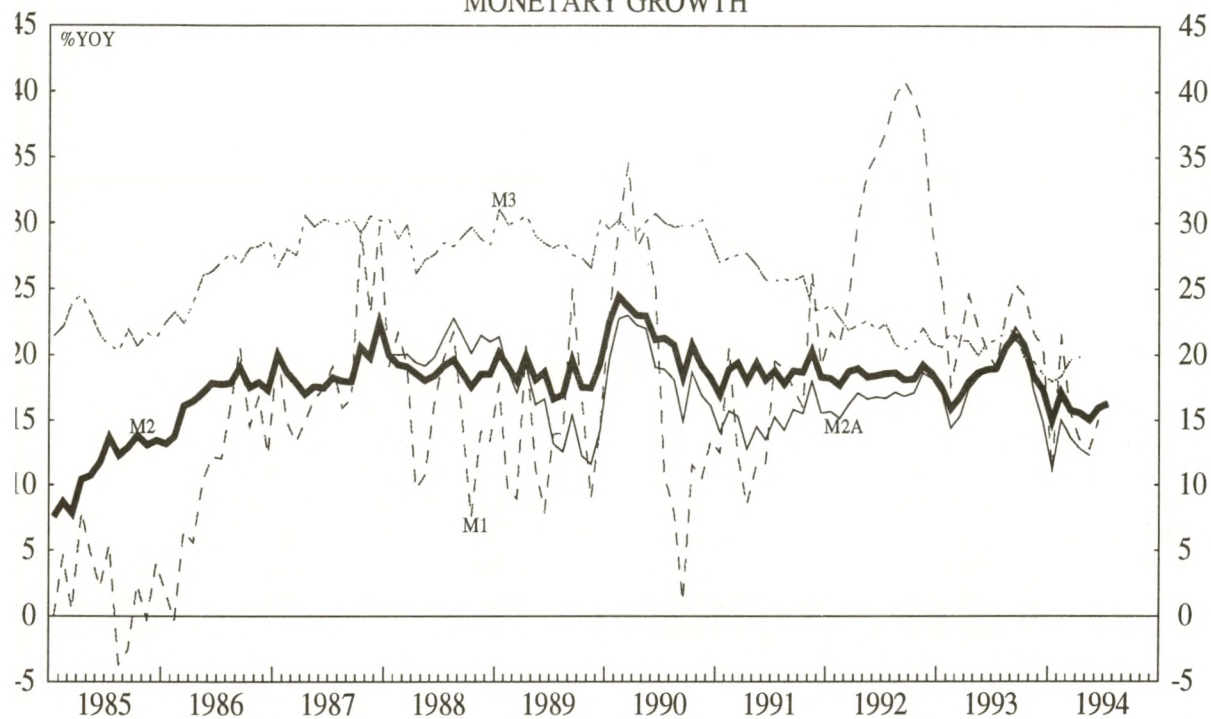
The most likely liberalisation measure in the next few months is a 2%-3% increase in the current 10% foreign investment limits on the Korea Stock Exchange (KSE). The BoK is, however, very cautious when it comes to opening up to capital inflows; the similar magnitude of the KSE capitalisation and M2 is taken to imply that a 1% increase in the foreign investor limits will (in the absence of off-setting outflows or sterilisation) result in a 1% increase in M2, which could jeopardise their monetary targeting.

Monetary Policy Framework

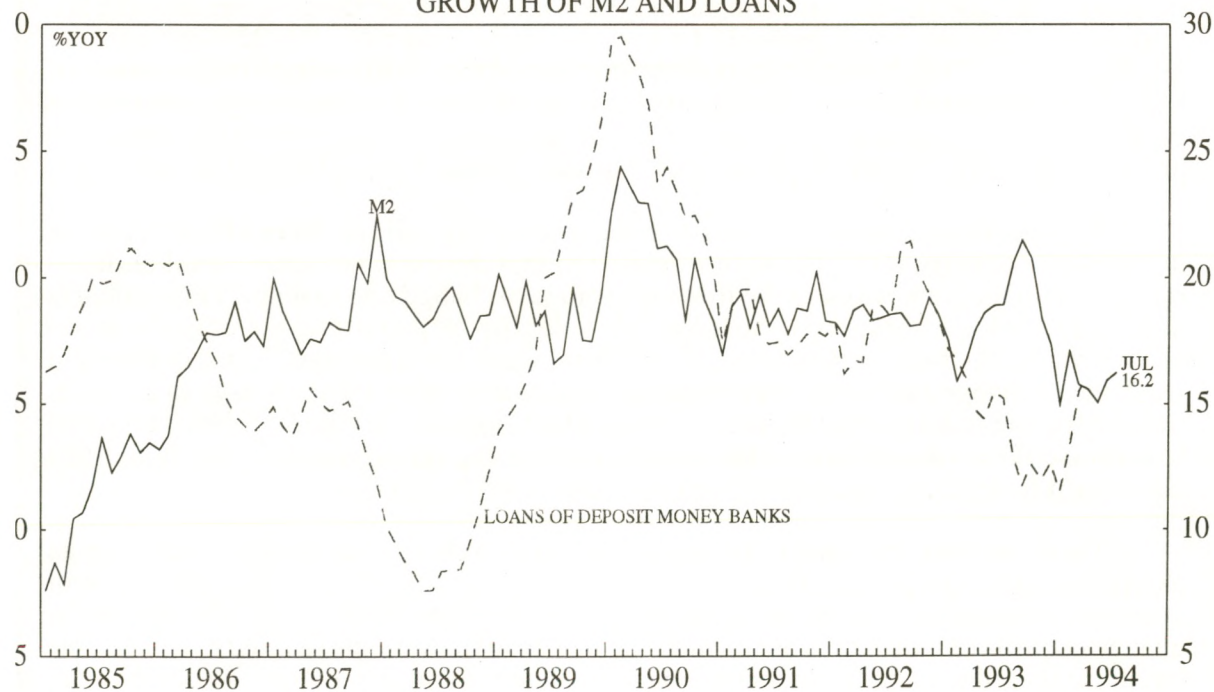
The BoK's framework for monetary policy has traditionally been the targeting of M2 or M2A (M2 less long-term bank deposits) within a fairly narrow range, with the target range periodically adjusted to reflect concerns about growth, inflation, balance-of-payments, etc. Although this choice of monetary target can be argued to approximate short-term banking sector liquidity and money demand for transactions and precautionary motives, it is more likely a pragmatic choice reflecting the shortcomings of other aggregates. M1 (currency and demand deposits) is too narrow a measure of short-term liquidity and its relationship to economic activity is too unstable to form the basis of monetary targeting. While M3 (M2 plus deposits with non-bank financial institutions plus various money-market instruments) is too broad a measure of liquidity to be measured on a sufficiently timely basis for monetary targeting, and many of its components (deposits with NBFIs and the issuance of some money-market instruments) are beyond the direct supervisory control by the BoK.

Not surprisingly the BoK has been very successful in keeping year-on-year growth rates of M2 (or M2A) within the chosen target bands. Even so, the BoK has been prepared to initially relax (and subsequently tighten) its monetary targets in response to specific events affecting the monetary structure. The money supply was allowed to grow at a faster rate during the limited opening of the stockmarket to foreign investors in January 1992 and during the introduction of the real-name system for financial transactions in August 1993, while monetary conditions were tightened at the end of those years when end-year inflation was about to stray into double-digits, and/or end-year money figures were about to exceed the target.

S. KOREA: CHART 8
MONETARY GROWTH



S. KOREA: CHART 9
GROWTH OF M2 AND LOANS



In the past this accuracy and success of monetary targeting was achieved through pretty tight BoK control over the banking system. Indeed, the pre-liberalisation banking system could be regarded essentially as the operating arm of the government's quasi-fiscal industrial policy. The authorities claim to have replaced this direct control over the banking sector with open-market operations. However, anecdotal evidence suggests that the BoK still gives commercial banks substantial guidance on lending operations, and even on the price and quantity of commercial banks' bids for Monetary Stabilisation Bonds (MSBs) -- the BoK's main money market instrument for mopping up or providing liquidity. Although a fair amount of financial liberalisation has taken place, at least on paper, the authorities are still clinging to the old-fashioned mechanisms of monetary control: controlling the level of credit, its price, and (to a diminishing extent) even its allocation. Clearly the financial liberalisation effort has some way to go.

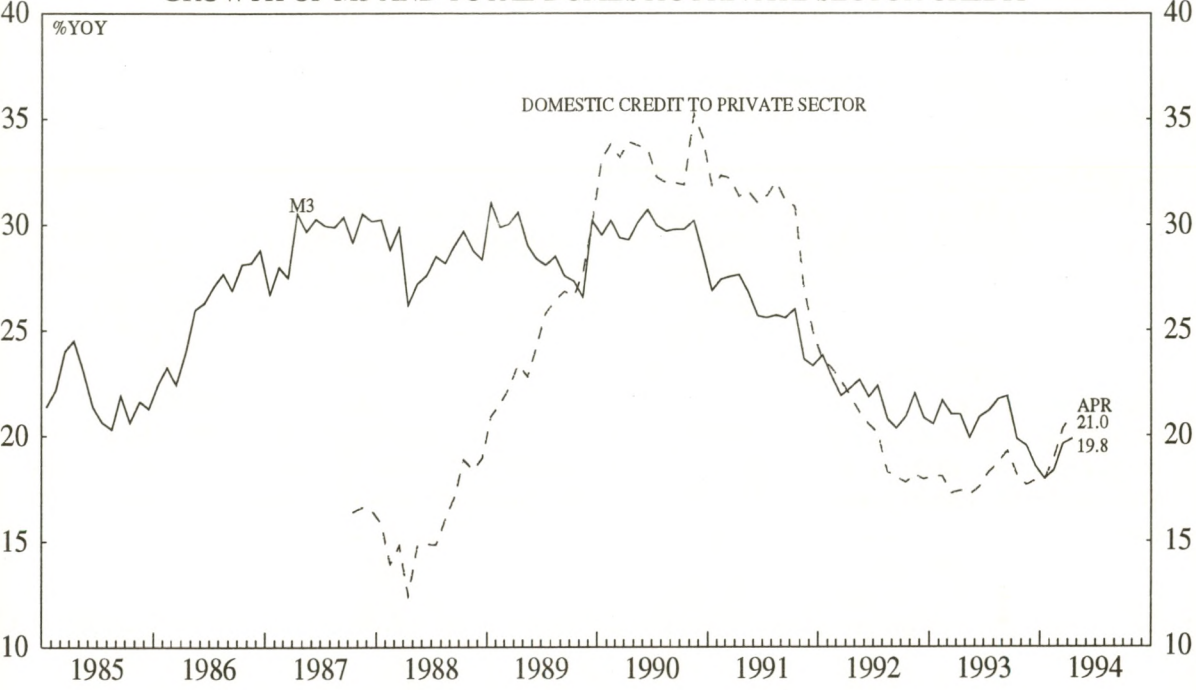
The question inescapably arises whether M2 targeting is an appropriate monetary policy framework for Korea. It might have been appropriate in 1976 when M3 was first measured and M2 accounted for 81% of M3, or even in 1983 when M2 accounted for 62% of M3, but not by 1993 when M2 was only 32% of M3. Effectively, the BoK's targeting of M2 has constrained the growth in banking sector assets and liabilities while allowing an almost unbridled pace of growth in the assets and liabilities of the non-bank financial sector. There are signs that the authorities realise this; part of the financial sector reform process is aimed at leveling the playing field by redefining the business scope of banks and NBFIs, and the authorities are talking privately of moving to a policy of targeting a wider monetary aggregate.

However, the most likely new monetary target is not M3, which would be too difficult to control at this juncture, but M2+CDs. CDs have grown in popularity in recent years because they carry a market-determined interest rate, are marketable, and do not require the identity of the holder to be revealed to the authorities (important to many savers with the introduction of the real-name financial system). Also, M2+CDs has been growing at a fairly stable rate and could probably be kept in a target range of 18%-22% without too much difficulty. This, however, ignores the problem of the NBFIs being a major source of M3 growth and broad domestic credit, and being beyond the direct monetary control of the BoK. Essentially it would be patching up a monetary policy framework which is inappropriate for the market-based financial system towards which Korea claims to be moving.

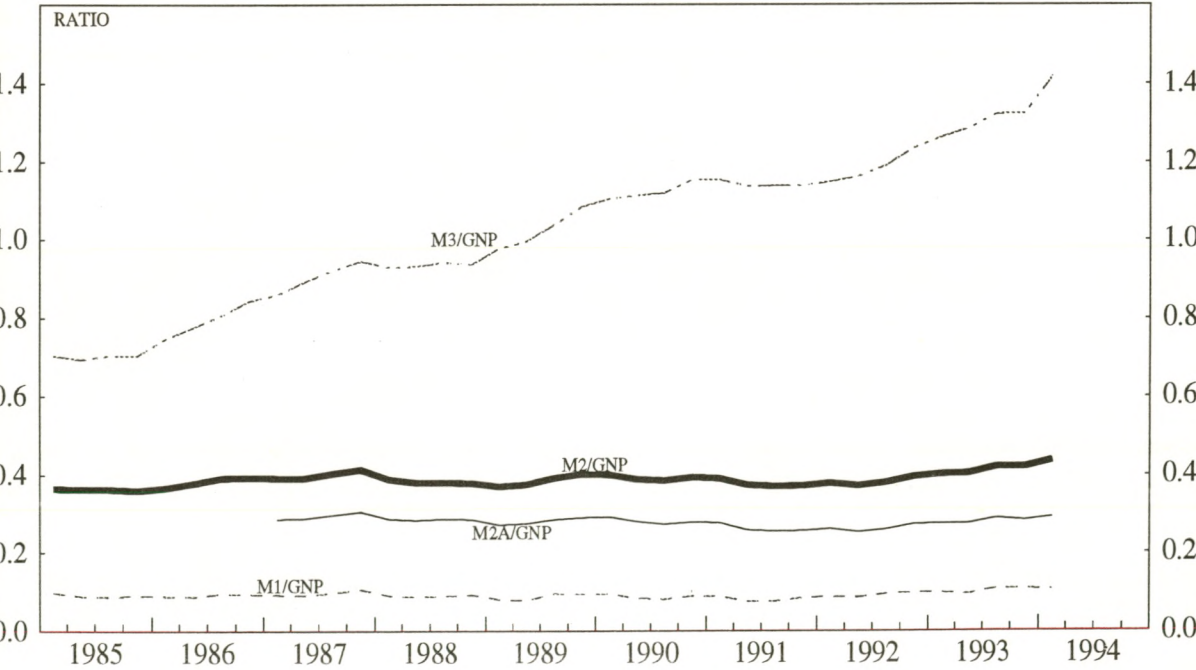
Another, less acknowledged, instrument of monetary policy has been the level of the dollar-won exchange rate. The authorities claim that the exchange rate is market-determined within the framework of the moving average exchange rate system. This system is designed to smooth short-term exchange rate volatility by permitting the dollar/won exchange rate to fluctuate only within $\pm 1\%$ of the previous day's average. Thus, in theory at least, the exchange rate could appreciate or depreciate by upto 1% each day. In practice, the remarkable stability over the past year and a half suggests that the BoK has intervened to stabilise the exchange rate. The effects of stabilising the won against the dollar and allowing it to depreciate against the yen were discussed earlier.

There are pros and cons of pursuing a specific exchange rate policy. Targeting an external nominal anchor can be a useful monetary policy rule if there is a high degree of economic integration with the external sector. On the other hand, in the absence of exchange controls (which Korea are committed to dismantle over time) a fixed exchange rate circumscribes the scope for pursuing an independent monetary policy. While Korea's economy remains very dependent on external trade, its domestic economy is substantial

S. KOREA: CHART 10
GROWTH OF M3 AND TOTAL DOMESTIC PRIVATE SECTOR CREDIT



S. KOREA: CHART 11
MARSHALLIAN K



and full of distortions in both factor markets and goods markets. While pursuing economic and financial liberalisation to address those distortions, the authorities will need flexibility to adopt an appropriate monetary stance. They will therefore need either to maintain exchange controls for a longer period of time (which risks prolonging price distortions) or to float the exchange rate fully, if they are to have the freedom to pursue an independent monetary policy.

SUMMARY AND CONCLUSIONS: Korea's impressive recovery since early 1993 has been fuelled by monetary and fiscal stimuli. The government's main priority is to sustain that pace of growth, and the recent tightening in monetary conditions by the BoK should be viewed as a temporary phenomenon, which the MoF will reverse if it is seen to threaten the recovery. The prospects for further financial liberalisation looks encouraging, partly because Korea wants to strengthen its case for OECD membership by fulfilling GATT Uruguay round commitments and making further gestures, and partly because Korea realises that its future economic growth hinges on long term efficiency gains achievable only through economic and financial sector reform. Interest rate deregulation should result in lower costs of intermediation, while higher foreign investment limits, even if they erode foreign premiums, should improve stock market liquidity and the outlook for equity prices.

THAILAND JUDGING THE STRENGTH AND LENGTH OF THE NEXT ECONOMIC CYCLE

Introduction

Real economic activity reached a trough from mid to late 1992 after having slowed down from its peak in 1989. From 1992 to the present day the economy has posted a moderate recovery (Chart 1). This article will try to gauge the strength and length of the current economic recovery using previous monetary cycles as a guide. Since 1980 there have been three complete cycles of monetary growth in Thailand labelled A to C in Charts 2 to 10 and it is entering a fourth labelled D. It will be seen that although interest rates became less rigid over the 1980s, clear cycles in the growth of monetary base, M2 and credit have emerged generated principally by: (1) the fixed or quasi-fixed exchange rate to the US\$ and hence movements in US interest rates relative to Thai rates and (2) by the trade and current account balances which themselves are a product of global (OECD) economic growth and domestic demand.

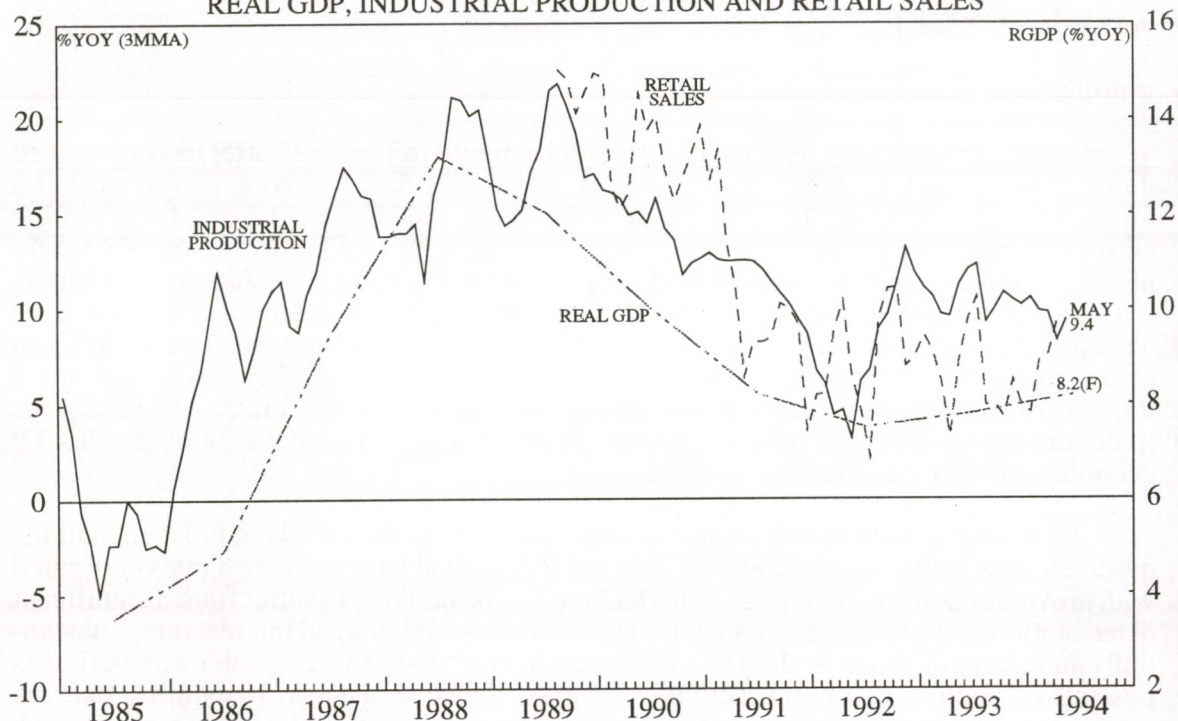
Given the asynchronous economic recoveries across the OECD in prospect and the moderate acceleration in the domestic demand for credit at current interest rates compared with previous upswings, it appears that Thailand will be unlikely to suffer from a significant deterioration in its current account deficit necessitating higher local interest rates substantially in excess of those in the US. However, a slight worsening of the trade deficit is possible as credit and economic activity remain buoyant over the next 12 months. Instead, higher domestic interest rates will result from a continuation in the rises in US rates through 1995. These will likely not be sufficient to bring about a significant monetary tightening until well into 1995. In addition rises in domestic interest rates in the year ahead should be more than sufficient to attract the inflows of capital required to finance the current account deficit without inducing a significant slowing in economic activity. We now turn to consider the previous three cycles.

Cycle A: 1979-81

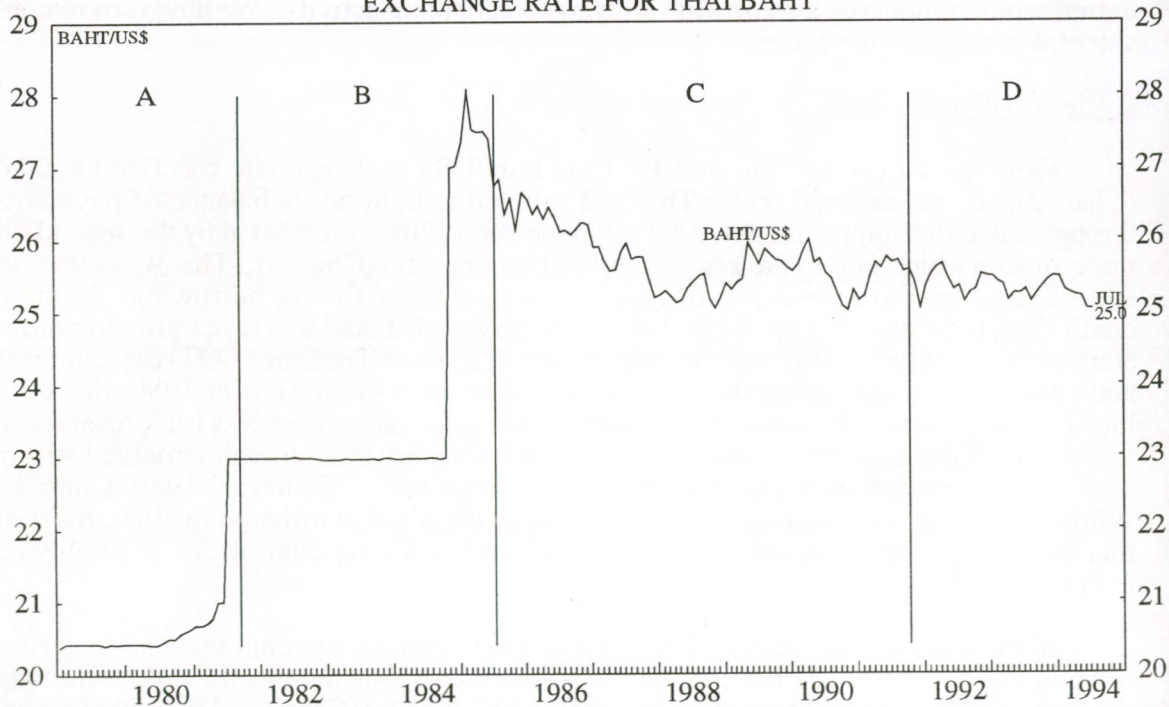
From the start of 1979 to mid-1981 the Baht/US\$ exchange rate was fixed at 20.4 (Chart 2). In the external sector Thailand suffered a drain on its balance of payments through a deterioration in the trade deficit in the late 1970s, exacerbated by the second oil price shock (which put up the price of 30% of its imports) (Chart 3). This was offset to some degree by a higher quantity of government guaranteed foreign borrowing. As these credit lines were drawn down in the late 1970s they contributed to a faster growing monetary base. In addition, although the (administered) Bank of Thailand (BOT) discount rate had been raised a number of times from the end of 1978 to the start of 1980, the BOT introduced a number of stimulative measures designed to increase excess bank reserves in the system at the given discount rate. As a result monetary base growth remained strong fuelling an acceleration in M2 and credit growth from mid-1979 to mid-1980 (Chart 4). While this contributed to some of the observed acceleration in inflation in 1980, most of this inflationary spike was attributable to the relaxation of price controls, most notably on petrol (Chart 5).

In the US from the start of 1979 to mid-1981 3-month nominal interest rates rose from around 8% to 15% before coming down to around 8% again, by mid-1982 following the decline in US inflation from its maximum of 14% in 1980 (Chart 6). This had a powerful tightening effect on Thailand, which had its currency rigidly pegged to the US\$ at the

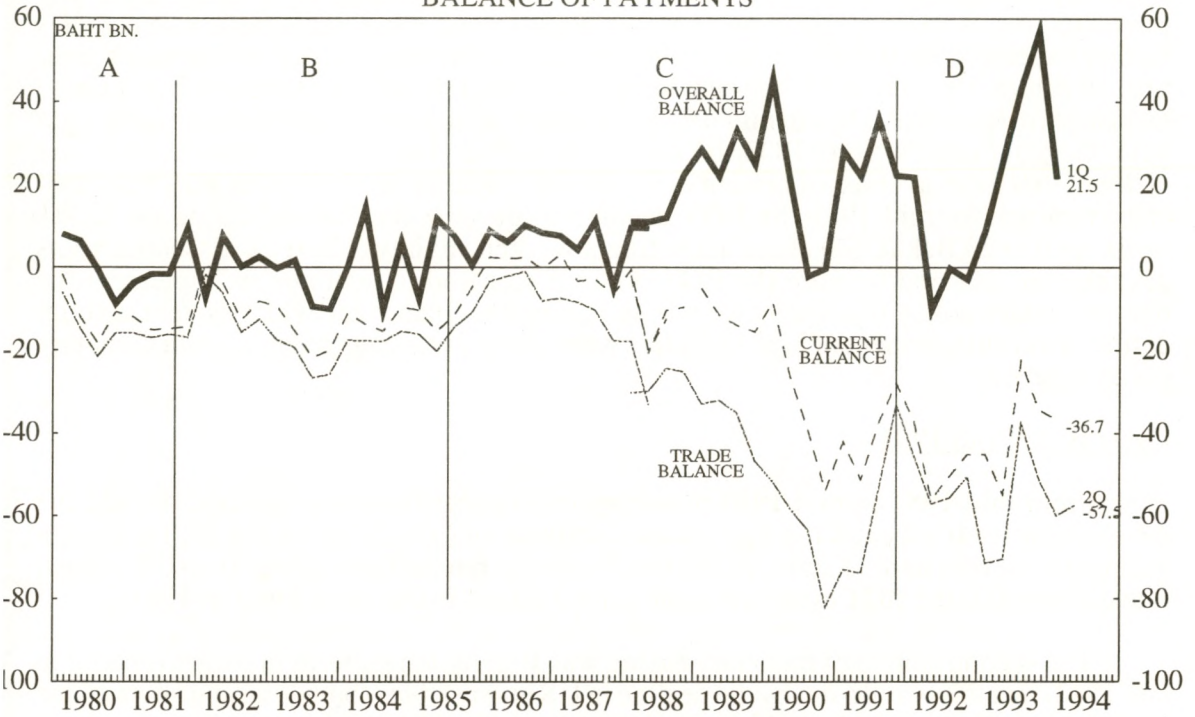
THAILAND: CHART 1
REAL GDP, INDUSTRIAL PRODUCTION AND RETAIL SALES



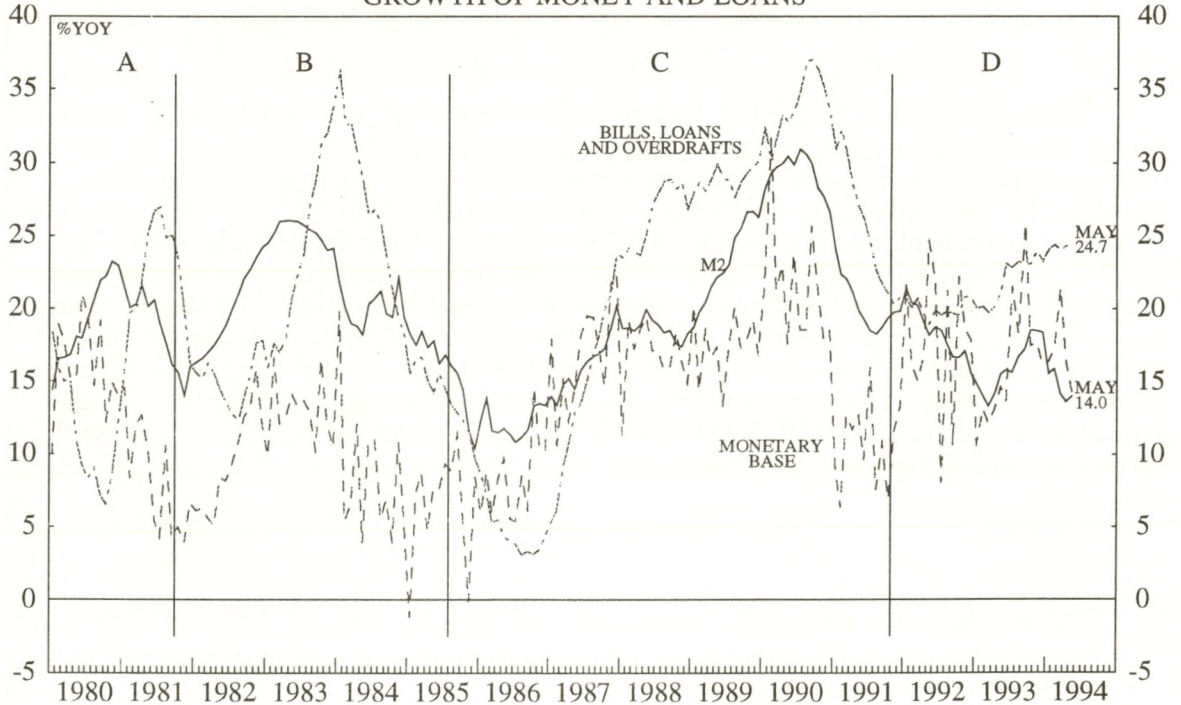
THAILAND: CHART 2
EXCHANGE RATE FOR THAI BAHT



THAILAND: CHART 3
BALANCE OF PAYMENTS



THAILAND: CHART 4
GROWTH OF MONEY AND LOANS



time, it was simultaneously experiencing a widening current account deficit. Thailand's monetary base growth contracted sharply from mid 1980 to mid 1981 as the BOT was forced to give up its easy stance on domestic liquidity and it raised domestic interest rates further to protect the Baht/US\$ rate in the face of a weakening balance of payments position. By mid-1981, the BOT had run down approximately a third of the stock of foreign exchange reserves that it had in mid-1980. Monetary policy had by then become quite tight with the real (administered) BOT discount rate having risen from an average of around -7% in 1980 to an average of around 2-3% in 1981. Rather than continue with this monetary rectitude in mid-1981 the BOT decided to devalue the Baht/US\$ rate by 12.7% (refixing it at 23 Baht/US\$) after first letting it weaken slightly (Chart 2). Essentially this devaluation occurred because the BOT was not prepared to continue to implement the tight monetary policy that would have been required to finance the wider current account deficit, in an environment of high US rates (when the US was engaged in its own monetary policy squeeze).

Cycle B: 1981 to 1985

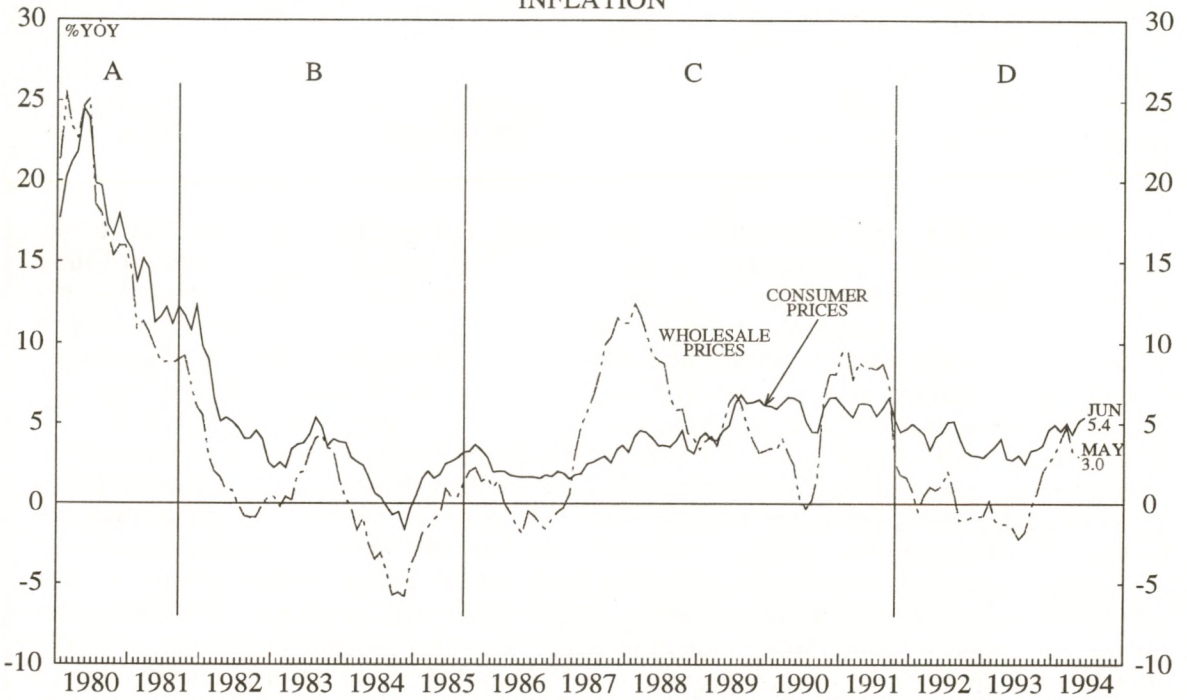
From mid-1981 to mid-1983 monetary relief came from two sources. Firstly the devaluation itself relieved the tight money markets and the drain on the BOT's foreign exchange reserves immediately. At the new exchange rate and prevailing Thai-US interest rate differentials the BOT even saw some capital inflow in the second half of 1981.

The second source of monetary easing was slightly longer term in nature (ending in late 1982) and this was driven by the decline in US interest rates (both long and short in line with the deceleration in the CPI in the US) (Chart 6). Nevertheless the high domestic interest rates in 1981 led the Thai economy into recession (Chart 7) and, the sharp deceleration in reserve money growth over 1980-81 was followed by a similar slowdown in the growth of both broad money and private sector credit. The rate of inflation came down from around the 25% peak in 1980 to under 5% by the end of 1982 (Chart 5), while the trade deficit stabilised adjusting for the immediate price effect of the devaluation.

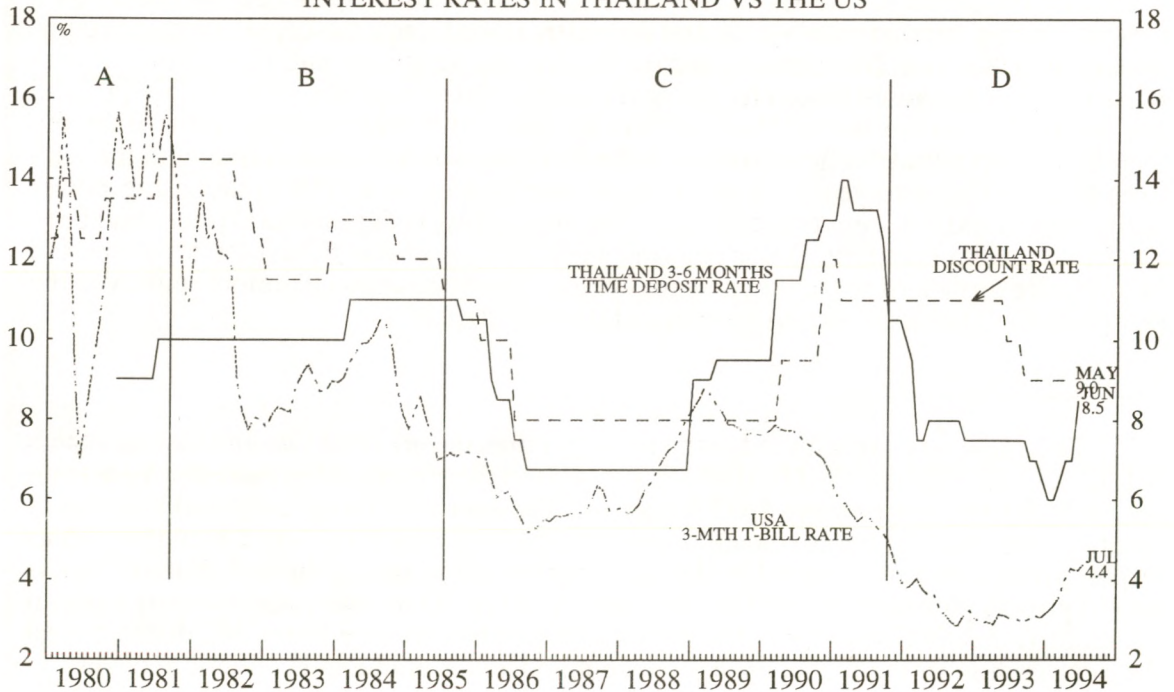
From mid-1981 to mid-1983, money and credit growth received a strong impetus from the decline in local interest rates which followed those in the US. Previous inflows of capital reversed (Chart 8) and the economy was stimulated by the lower interest rates. In late 1982 the BOT reduced its discount lending rate in stages from 14.5% to 11.5% as well as the ceiling on bank lending rates from 19% to 17.5%. 1 year deposit rates were cut by a lesser amount from 12.5% to 11.5%. Rates in the repurchase bond market (and hence overnight interbank rates) fell sharply (Chart 6)¹. From mid-1982 to mid-1983 the economy recovered vigorously as monetary and credit growth enjoyed a strong upswing. Import growth accelerated earlier than exports growth and as a result, from 1982 to 1983 the trade balance deteriorated (Chart 9). However Thai exports accelerated on the back of a recovery across the whole of the OECD in 1983-84 (Chart 10), and this helped to stabilise the current account deficit over this time (Chart 3).

¹ Chart 6 shows the 3-6 month time deposit rate for Baht deposits. Movements in this rate are compared with those in the US 3 month T-Bill rate, due to the absence of an active 3 month money market rate in Thailand.

THAILAND: CHART 5
INFLATION



THAILAND: CHART 6
INTEREST RATES IN THAILAND VS THE US



One peculiarity of the Thai monetary system over this time concerns the upward rigidity in the interest rate structure. What typically happened was that the BOT would reset the ceiling on commercial banks' lending rates and its discount rate some time after those in the US had risen. This meant that at the given Baht/US\$ rate and for a given current account position the balance of payments position could deteriorate as borrowing costs overseas rose relative to domestic returns. This occurred from mid-1982 to mid-1983.

By the end of 1983, faced with extremely strong demand for credit, domestic banks were pressing the BOT to raise their lending rate ceiling and were funding more of their domestic lending operations through foreign currency borrowings despite the upward movement in US rates from the end of 1982 to the start of 1984 (Chart 8). In addition they switched out of their surplus government debt holdings, increasing the share of assets accounted for by private sector loans. The BOT was reluctant to raise lending ceiling rates due to their downward inertia once raised (however it had raised its discount rate to 13% by the end of 1983). Credit controls became the order of the day. Commercial banks were forced to hold a minimum of 14% (up from 10%) of their deposits as government bonds and restrictions were imposed on credit granted to importers, consumers, and the construction sector. Domestic real interest rates were driven up in 1983 by a combination of the imposition of these credit controls, rising US interest rates and by the deterioration in the current account deficit which subsequently improved slightly at the end of 1983 and remained moderately stable throughout 1984 (Chart 3). This monetary tightening led to a slowdown in credit and monetary growth over 1984 and 1985. Economic activity slowed down over this time reaching a trough in mid-1985.

Despite the upward trend in US interest rates from 1983 to late 1984 and the appreciation of the US\$ on world currency markets, net foreign capital inflows remained strong at around 4% of M2 (Chart 8). In November of 1984 the BOT devalued the Baht/US\$ a second time by approximately 17% and thereafter linked it to a basket of currencies comprising the US\$, Yen, DM, sterling and the Malaysian, Singapore and Hong Kong dollars (Chart 2). The supposed reason for the devaluation, which came as a shock to the financial and political communities in Thailand, was to reduce the overvaluation of the Baht and thereby correct a trade deficit. Although the Baht had strengthened in line with the US\$ over the previous two years, on a real trade weighted or on a (PPP) purchasing power parity basis it did not seem particularly overvalued. However agricultural prices had been weak and much of the OECD was entering a period of recession (Chart 10) after a period of moderate growth over the previous two years. The devaluation therefore improved the prospects for Thailand's export growth and its trade deficit.

Cycle C: 1986-91

This monetary cycle turned out to be longer than the previous two and like the others before it, it was characterised by the early upswing in the growth of the monetary base from the start of 1986 to the end of 1987 (Chart 4). The source of this growth was external in nature. There was an improvement in the trade balance which occurred over 1985-86 as import growth slowed (induced by the domestic recession and by the devaluation) and as export growth picked up in 1987 (on the back of an OECD recovery and aided by a rise in competitiveness in US\$ terms). The upswing in the growth of credit and M2 that followed the acceleration in the monetary base accommodated a dramatic economic recovery in Thailand, one which led to a huge surge in imports and reversed the improvement of the trade deficit. From 1987 to 1990 Thailand experienced a substantial widening in the trade

deficit which completely overshadowed the deterioration experienced in the last cycle over 1983 (Chart 3).

From 1988 to 1990 Thailand's interest rates were forced up relative to those in the US by the need to finance the widening trade and current account deficit and by the very strong demand for credit at the prevailing interest rates. US rates, rose from the start of 1988 reaching a climax in early 1989. Thailand's interest rates continued to rise 12-18 months after those the US began to fall. The fiscal deficits which the government had been running through the 1980s switched to surpluses from 1987-88 onwards. Part of these surpluses have been held at the BOT every year since then. Over time this has offset some of the boost to monetary base growth caused by a rise in the BOT's net foreign assets. The widening differential between 3-month rates in Thailand and the US from mid-1988 to mid-1990 enabled Thailand to attract a considerable quantity of foreign capital, more than compensating for the current account deterioration. Net foreign liabilities of the commercial banks as a proportion of M2 rose to around 2.5% by end 1988 (Chart 8).

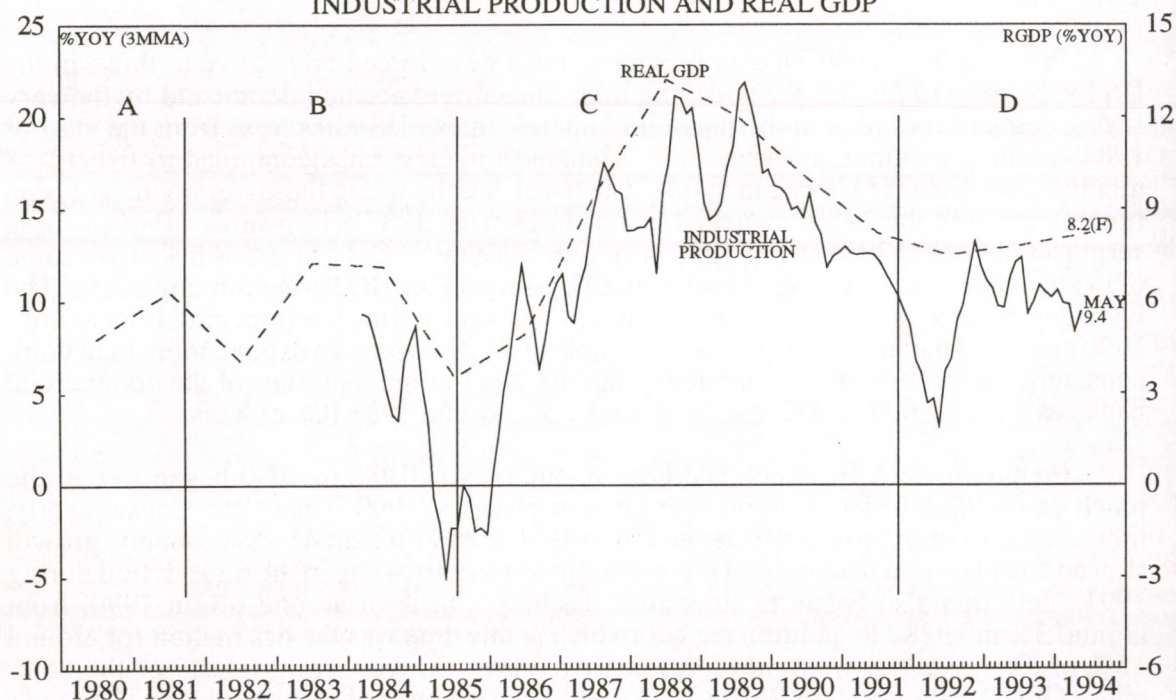
Economic activity, which had been booming over 1988 to 1990 began to feel the pinch of the higher domestic interest rates in place by 1990 (Chart 7). Consequently, monetary and credit growth decelerated from 1990 to 1991 (Chart 4). As economic growth slowed so did import demand and this contributed to a narrowing in the trade deficit during 1991. Inflation also began to slow after reaching a peak of around 6% in 1990, from around 3% in 1988. In addition the US (which at this time was the destination for around 25% of Thai exports) went into recession over 1989-90 recovering (ahead of the other major OECD economies) in 1991-92. This to a large extent explains the cycle in Thailand's exports growth and to a lesser extent explains a similar cycle in the trade deficit from 1989 to 1992 (Charts 3 and 9). The narrowing in the trade deficit coupled with the substantial decline in US short rates which started in 1989 (a trend which was to continue until the end of 1992 and which enabled Thailand to attract an increasing quantity of foreign capital) contributed to an improvement in the balance of payments in 1991. By the end of 1991 the current account deficit had improved somewhat and the economy was in a recession.

The Outlook for Cycle D based on Previous Cycles

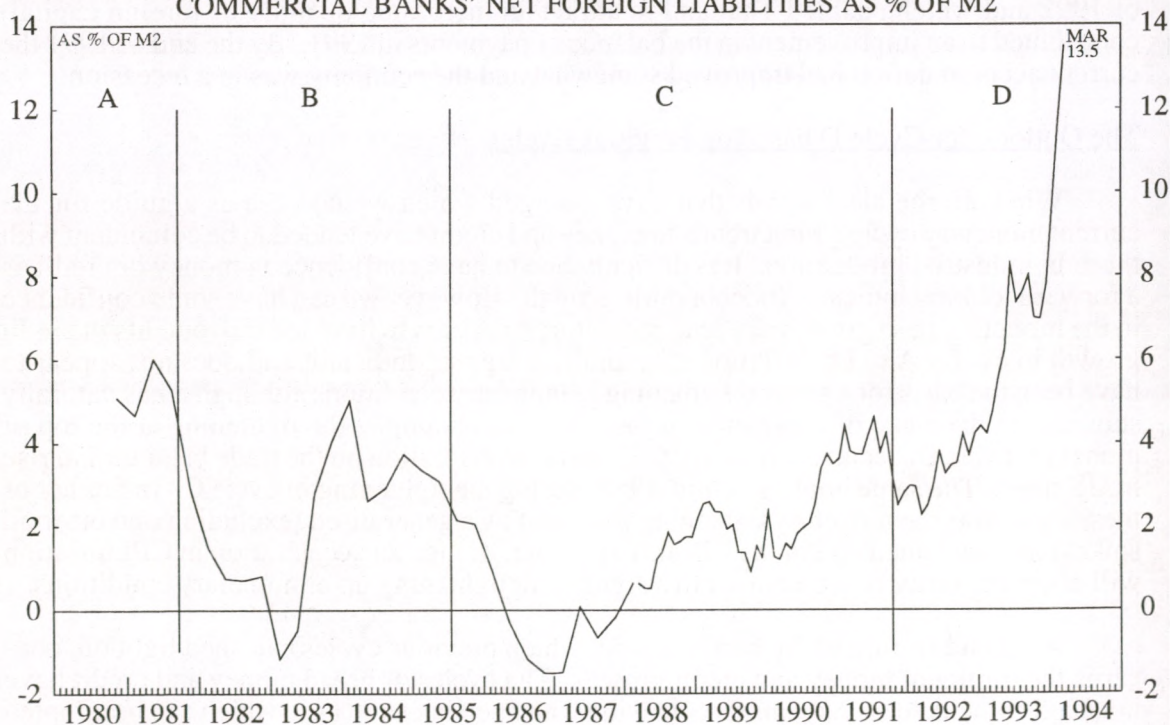
What are the clear trends that have emerged which we can use as a guide for the current monetary cycle? First trends in money and credit have tended to be coincident with those in industrial production. It is difficult then to have confidence in money or credit as a forward looking indicator for economic growth. However we can have some confidence in the monetary base growth as a lead indicator; it appears to have led movements in credit growth in cycles A to D. Inflation is naturally a lagging indicator and does not appear to have been the basis for a general tightening in monetary conditions although it has naturally subsided in the wake of a monetary tightening. For example, the tightening at the top of monetary cycle B, occurred in mid-1983, after a deterioration on the trade balance and rise in US rates. The same applies in mid-1988, during the tightening in cycle C. In neither of these cases was the monetary tightening preceded by a generalised (excluding one off food spikes) and sustained rise in the CPI inflation rate. Hence an acceleration in CPI inflation will not necessarily be a precursor to a significant tightening up of monetary conditions.

A second feature of the current cycle, which previous cycles can shed light on, concerns the timing of money and credit growth. The cycles of broad money and credit have not been coincident with themselves leaving it an open question as to which can be adopted as a suitable monetary indicator of economic activity. In cycles A and B it was broad money growth that led credit growth, whereas in cycles C and D credit growth appears to

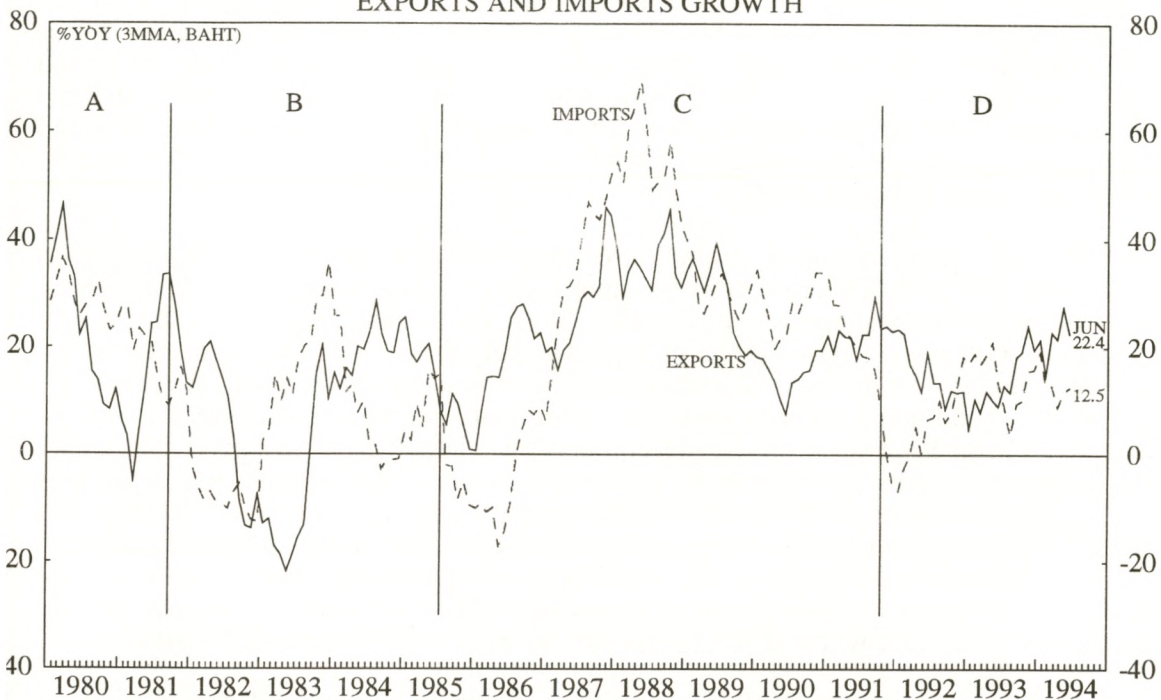
THAILAND: CHART 7
INDUSTRIAL PRODUCTION AND REAL GDP



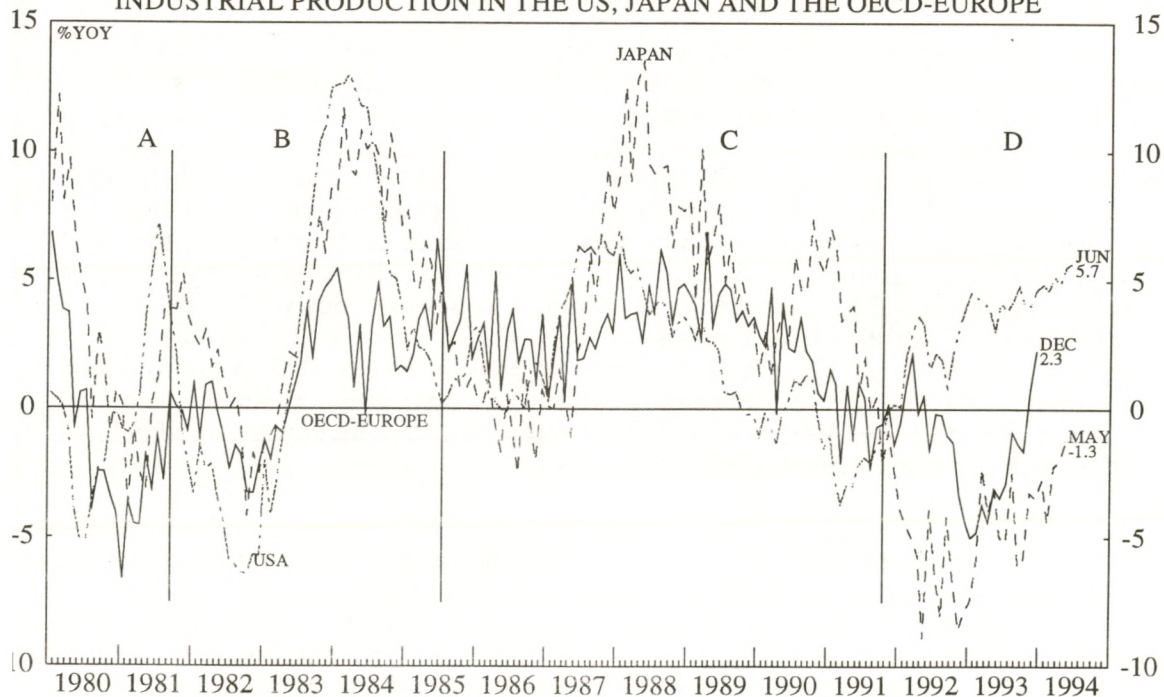
THAILAND: CHART 8
COMMERCIAL BANKS' NET FOREIGN LIABILITIES AS % OF M2



THAILAND: CHART 9
EXPORTS AND IMPORTS GROWTH



THAILAND: CHART 10
INDUSTRIAL PRODUCTION IN THE US, JAPAN AND THE OECD-EUROPE



lead broad money growth. The rapid development of finance and securities companies in the second half of 1980s goes some way to explain the divergence between credit and M2 growth in cycle C. If we enlarge the definition of both broad money and private sector credit to include this sector (Chart 11) these indicators match up quite well over the period of the divergence from 1989 to 1990. An important point to notice in cycle C is that the M2 indicator caught up with credit growth after a period of a year or so as these financial intermediaries participated in and contributed more fully to the (dynamic) deposit creation process across the financial sector.

The same phenomenon of strongly growing credit with subdued monetary growth appears over 1992-93. This can partly be explained by the rapid emergence (from a small base) of mutual fund management companies. There are around 80 mutual funds (mostly closed end) with around Baht 200 bn or approximately 8-9% of M2 under management. The environment over the last 1-2 years has been particularly conducive to the establishment of these fund management companies. Local (and international) interest rates have been low over the last two years. In addition they have benefited from a general move by the BOT to try and free up the financial system. However as deposit rates rise in the next couple of years the pace at which new fund management companies emerge will subside as will the growth of existing ones and this will be one factor contributing to an acceleration in M2. In addition as in the previous case involving the expansion of finance and securities companies, we are experiencing a one-off slowing in M2 growth as deposits are initially drawn away from bank accounts and redeposited elsewhere in the financial system.

Other attempts by the BOT to liberalise the financial system and generally lower commercial bank spreads include the introduction of an offshore banking facility in spring of 1993. This essentially involved the removal of an array of taxes on foreign currency deposits and borrowings making it cheaper for Thai entities to fund their domestic operations using foreign currency (see box).

Chart 8 shows the net foreign liabilities position of commercial banks (net deposits and borrowings in foreign currency, mostly in US\$) as a proportion of M2. Here it can be seen that in previous cycles banks were less reliant on foreign liabilities as a source of funding in the early stages of a monetary cycle (when domestic interest rates are on their way down) when monetary and credit growth are on their way up. However when domestic rates began to rise, (restraining the domestic demand for credit) it became cheaper for a growing number of banks to source funds from abroad, hence net foreign liabilities as a % of M2 rose. The beginning of this cycle in 1992 was not characterised by as sharp a rundown in commercial banks' net foreign liabilities as has previously been the case. Indeed net foreign liabilities have expanded to new highs since the start of this cycle, in response to the prolonged historically low interest rates in the US. This presents another explanation for the divergence between M2 and bank credit in 1993. When the increase in net foreign liabilities over 1993 is added to M2, much of the recent upward trend in banks' credit growth can be explained (Chart 12).

In March, net foreign liabilities as a proportion of M2 were at an all time high of 13.5%. On close inspection it can be seen that after an increase in this ratio has occurred there is (usually) a small rise in M2 growth itself as these funds feed through the whole banking system and contribute to a multiple expansion of domestic bank deposits. However, soon afterwards when the Thai-US short interest rate differential falls by a certain amount, foreign liabilities contract and this offsets the general rise in M2 growth. We can observe this in cycles B and C. The net foreign liabilities/M2 peaks in mid-1983, end 1980 and mid-1991 were followed around 6-12 months later by an upturn in M2 growth of

May-June 1994

varying magnitudes. On this basis one would expect this effect to contribute to an upturn in M2 growth in 6-12 months time. This will be relatively large if the oncoming narrowing in the Thai-US differential is not sudden enough to lead to a dramatic outflow of funds (necessitating substantially higher local rates).

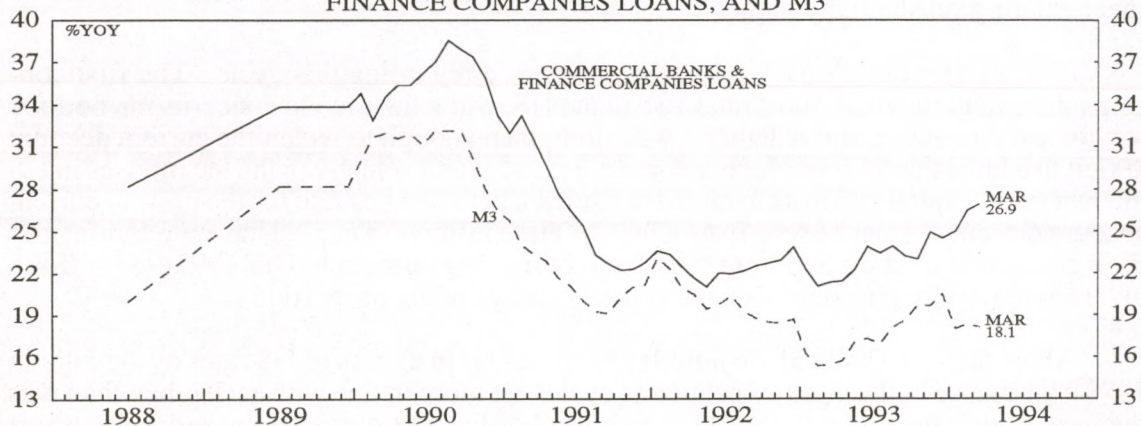
Two further questions remain to be addressed regarding this cycle. The first concerns the extent to which short rates rise in the US, while the second concerns the outlook for domestic demand, and whether it will strengthen enough to widen the current account deficit to a level that requires higher domestic rates. At present given the recent rises in US interest rates, capital inflows are more than sufficient to compensate for the present current account deficit. As can be seen from Chart 13 these inflows of capital have predominantly been composed of short and long term bank borrowing, although over 1992-93 portfolio investment (equity plus debt securities) has been a growing proportion.

Short rates in Thailand are unlikely to rise as far in excess of US rates as they did in 1988-89 because both countries economic cycles are more in line with each other, than was the case at that time. In 1988-89 the US was heading for a recession (and lower short rates) while Thailand was enjoying a rip-roaring boom (spelling higher rates). To this extent then the current cycle resembles that in 1982 to 1984 (a much shorter cycle). However, this cycle differs from cycle B as credit growth is unlikely to accelerate as rapidly in the year ahead as it did in 1982-83. This is due to the different pattern of growth across the OECD which has driven Thailand's exports. In 1983 (and in 1986-87) the upswings in economic growth in the major economies within the OECD were pretty much together (Chart 10). However since 1988 these major countries' cycles have completely desynchronised such that the US is now growing rapidly and strengthening, while Japan is still only just past the trough of recession, with the European economies sitting in between, some facing higher interest rates while others face lower.

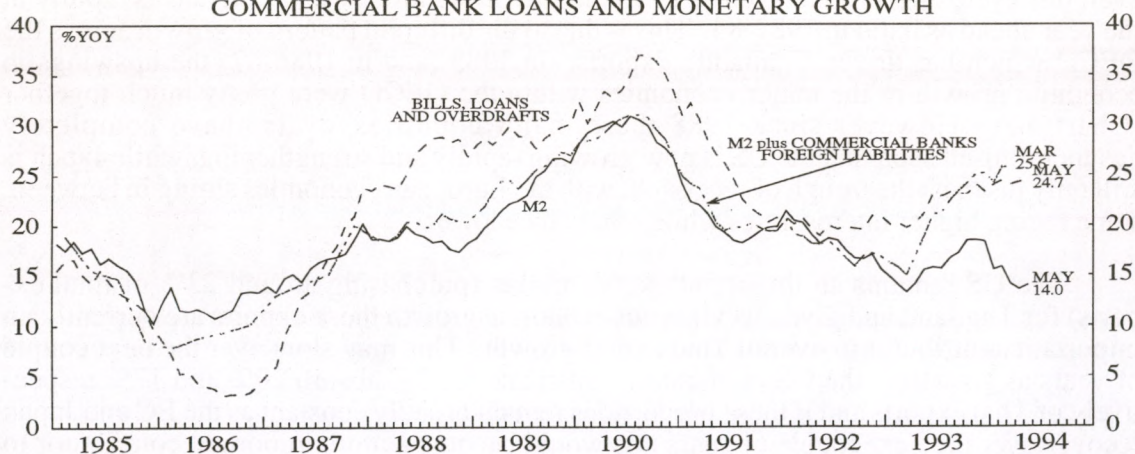
The US remains an important export market (purchasing around 23% of total exports) for Thailand and given its vigorous economic growth these exports are currently an important contributor to overall Thai export growth. This may slow over the next couple of years as growth in the US moderates. Japan and the EC absorb 20% and 17% respectively of Thai exports and if these proportions remain broadly constant as the EC and Japan recover over the next couple of years this would become a more important contributor to Thailand's export growth. ASEAN plus Hong Kong, Taiwan and Korea (a "high growth" region of the world) absorbs 24% of Thailand's exports. As the EC and Japan emerge more sustainably from recession over the next 1-2 years Thailand's exports to these countries (both direct and via Asia) should accelerate.

The domestic economic growth within Thailand at present is not as rapid as that in the previous cycle (Chart 7) and so the impetus for a dramatic and sustained acceleration in imports is not yet present. However for reasons outlined earlier we can expect there to be an upturn in M2 growth over the next 6-12 months which would bring with it some expansion in economic activity. It can be seen from observing charts 4, 7 and 9 that the main upswing in import growth in a cycle typically occurs in the middle, or coincident with the cycle in credit growth. There has already been a mini-upswing in imports over 1992-93 in line with the recent upturn in credit. Credit has so far been expanding at a modest pace compared with previous cycles. Further acceleration will likely occur in 1995 before the ongoing increases in domestic interest rates begin to bite. Consequently there is scope for a further acceleration in import growth and deterioration in the trade and current account deficits. However, without a significant acceleration in exports growth (narrowing the current account deficit) the forthcoming peak in credit growth is unlikely to be as high as it has been in previous cycles.

THAILAND: CHART 11
GROWTH OF COMMERCIAL BANKS AND
FINANCE COMPANIES LOANS, AND M3

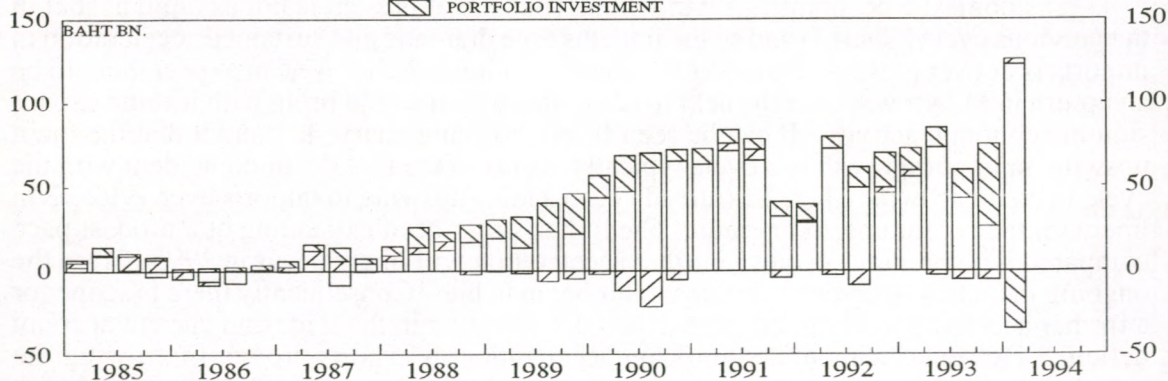


THAILAND: CHART 12
COMMERCIAL BANK LOANS AND MONETARY GROWTH



THAILAND: CHART 13
NET CAPITAL INFLOWS

[White Box] PRIVATE SHORT & LONG TERM LOANS
 [Diagonal Lines] NET GOVERNMENT BORROWING
 [Cross-hatch] PORTFOLIO INVESTMENT



SUMMARY AND CONCLUSIONS: On balance the current account deficit appears unlikely to deteriorate significantly over the next 12 months (in the same way it did in 1988-89) although a mild worsening in the current account deficit is possible over the next 12 months. US rate movements will therefore be the main force behind Thai interest rates. If US 3-month rates were to rise by 2% by the end of 1995 we might see a rise in 3-month Thai rates similar to that in cycle B; that is one averaging around 3%. Credit growth will likely continue to accelerate through 1995 as interest rates rise, although in the absence of an export boom credit growth will not repeat the dramatic acceleration to its peak that has occurred in the past. Once interest rates have risen far enough to check credit growth (possibly by late 1995) the outlook for a narrowing in the current account deficit brightens and inflation, which will have accelerated further by then would begin to slow. Given (1) a continuation of the moderate increases in US short rates in the year ahead (2) an asynchronous recovery across the OECD and (3) the current relatively moderate credit growth at current interest rates by previous standards, cycle D looks set to be more subdued than any of the previous cycles and of longer duration than A or B.

Bangkok International Banking Facility (BIBF)

BIBF was established in March 1993. BIBF operations can involve taking deposits or borrowing in foreign currency from offshore and granting credit in Thailand or abroad. BIBF also covers loan syndications and underwriting debt instruments for sale abroad.

Business booked under BIBF is liable to 10% corporation tax (instead of 30%), and qualifies for exemptions from the municipal tax (which is 3.3% of total turnover). Out-out transactions with non-Thai residents are exempted from withholding tax and the withholding tax on interest on foreign loans for countries without double taxation treaties, was reduced from 15% to 10%. In addition no reserves are required to be held against a BIBF booked borrowing although a 7% reserve ratio applies both to Baht and foreign currency deposits.

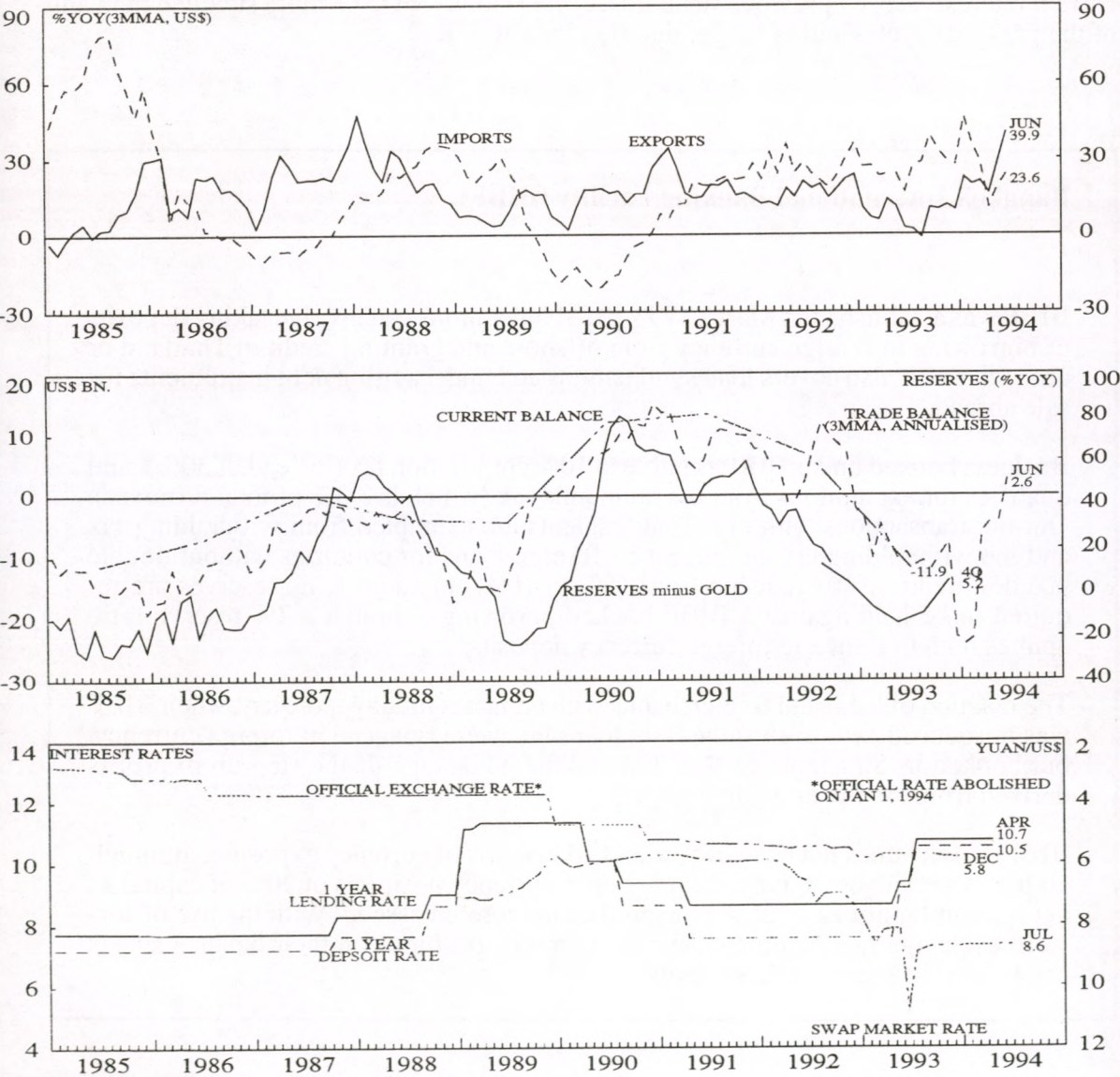
The reaction of local and foreign banks with branches in Singapore say, when BIBF was introduced, was to shift the Baht loans that were financed in foreign currency, but booked in Singapore to Bangkok, taking advantage of the step up in profits derived from the lower withholding tax.

BIBF activity does not have to be matched in terms of currency exposure, although all banks are subject to maximum net open currency positions of 20% of capital as net foreign liabilities or 25% of capital as net foreign assets. With the use of forward exchange rate contracts their net currency positions on their balance sheets can be well in excess of these limits.

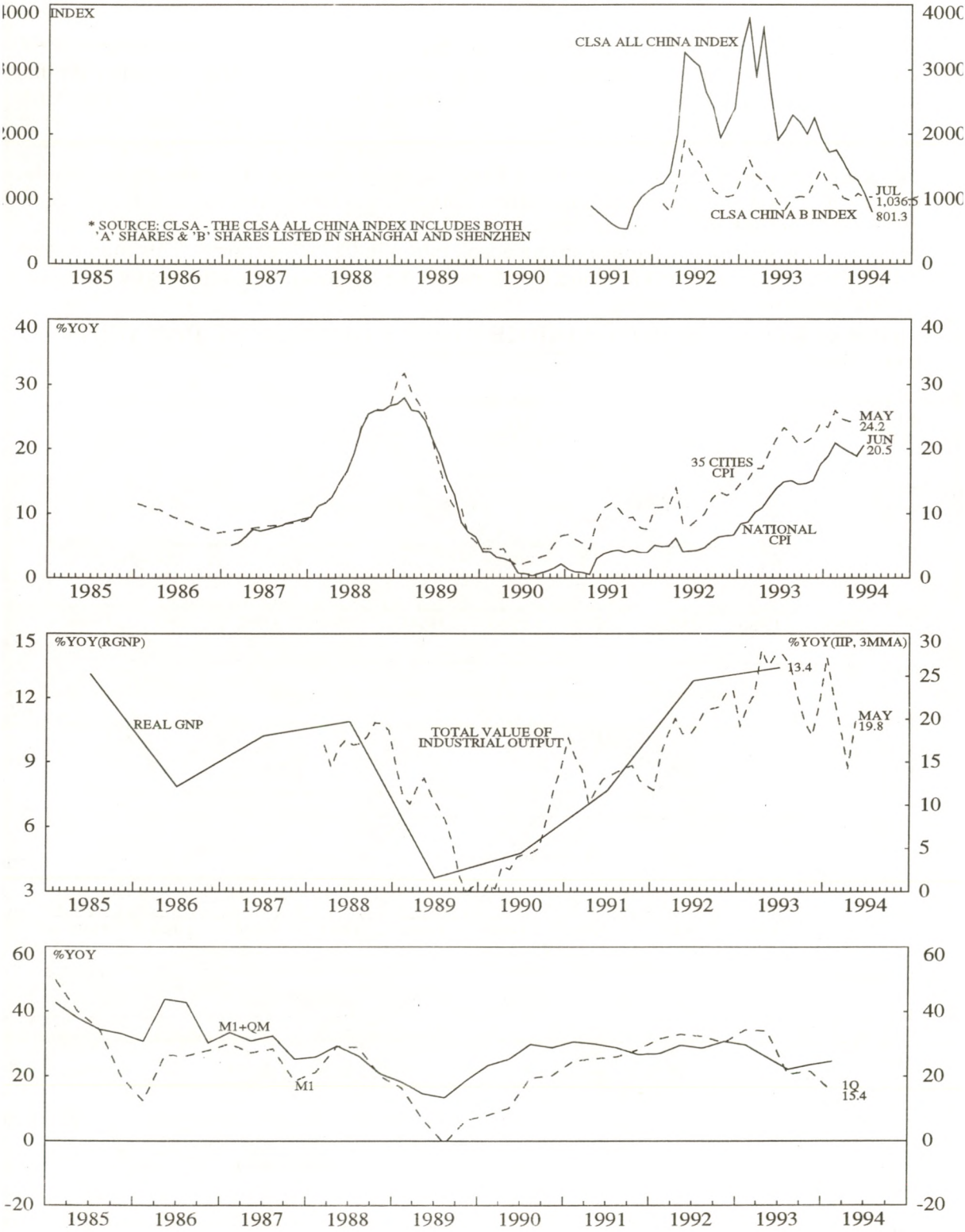
CHINA: TIGHT ECONOMIC POLICIES HAVE SOME EFFECT

The tight economic policies announced a year ago, and implemented with varying degrees of vigour since then, are showing signs of working. Money supply growth has been reduced and inflation has been capped (partly with reimposition of price controls); the exchange rate has been stabilised and the trade balance brought back into surplus (partly through curbs on imports); and the local "A" share markets had fallen by over 75% from their peaks. However, government spending in 1994 H2 of proceeds from 1994 H1 bond-sales, and injection of liquidity to ease problems of intercompany debt, may loosen monetary conditions to an unwarranted degree and necessitate harsher tightening in 1995. Nevertheless the efficiency gains associated with the ongoing steady switch in industrial production from the state to the private sector will contribute to continued strong economic growth and pave the way for financial sector reform.

CHINA: MONEY MARKET AND BALANCE OF PAYMENTS



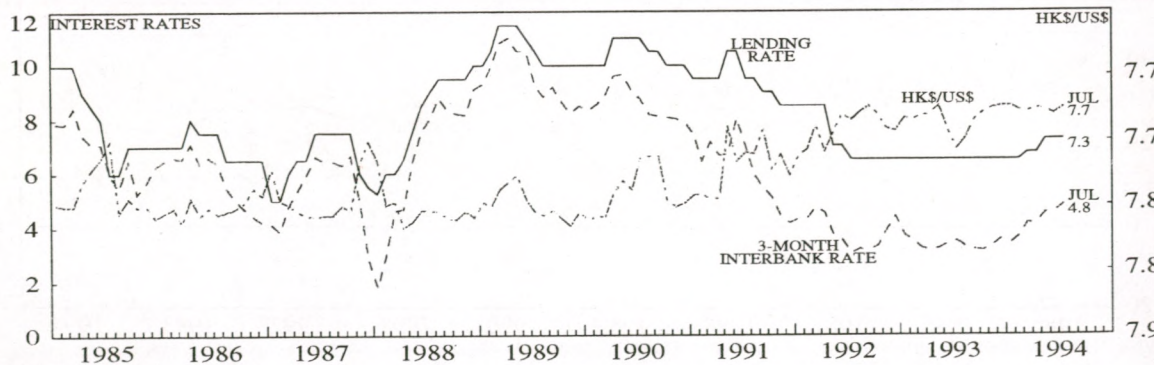
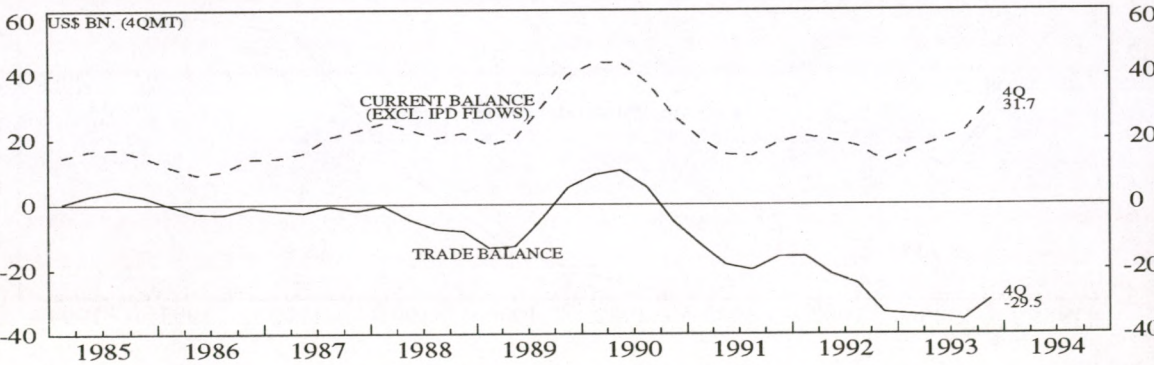
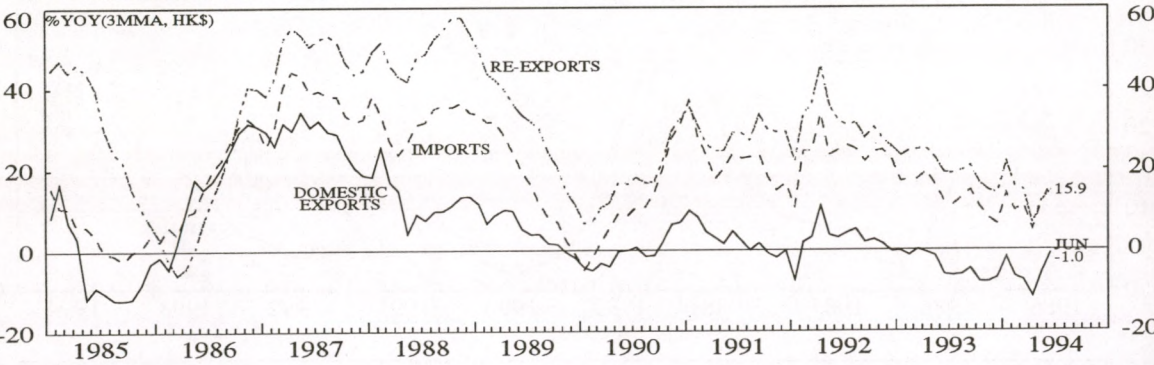
CHINA: MONEY, OUTPUT, GOODS AND ASSET PRICES



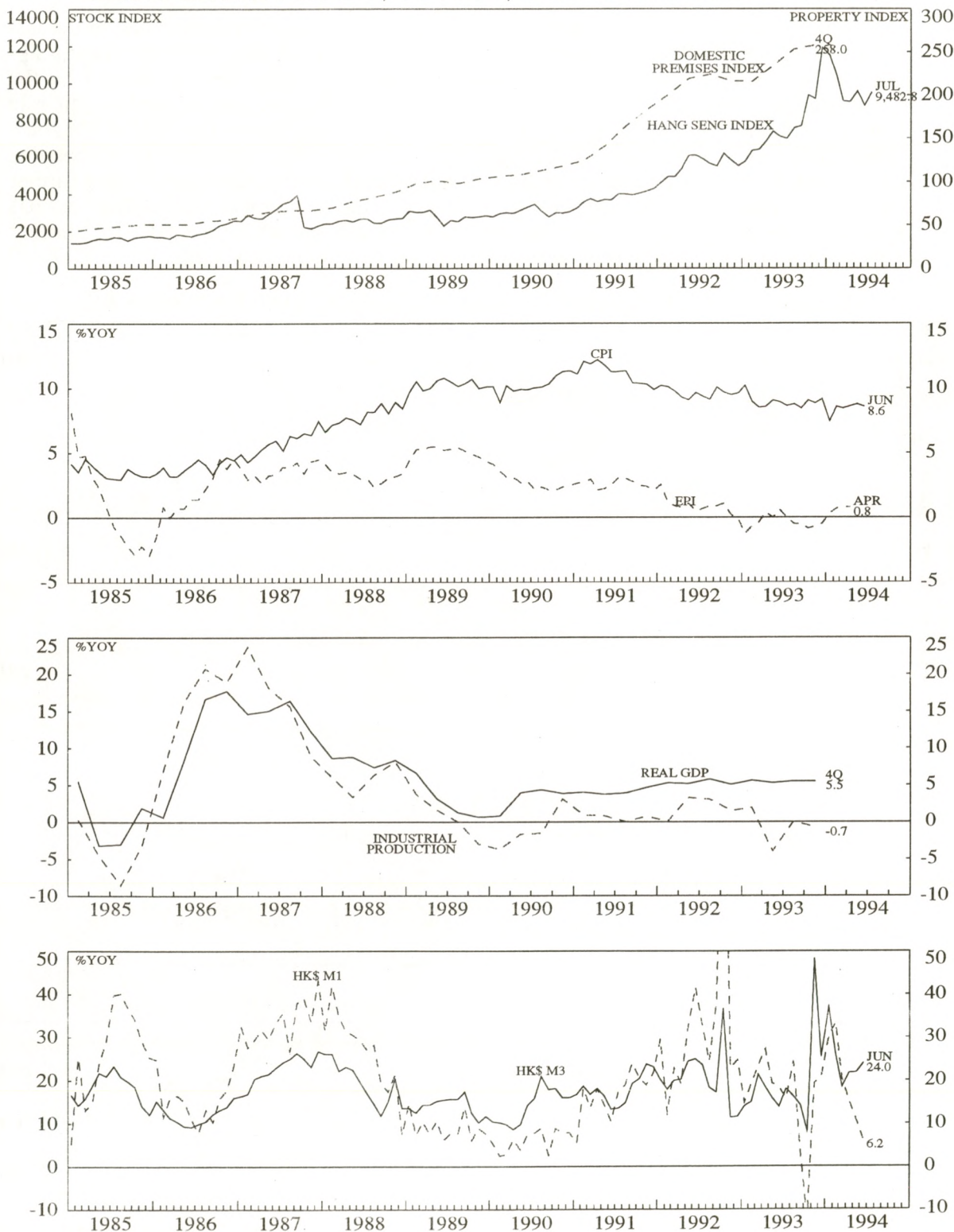
HONG KONG: RISING REAL INTEREST RATES HITS ASSET PRICES

With the HK\$ linked to the US\$, interest rates have to follow US rates very closely. Real short-term interest rates, which have been negative since 1991, have risen in line with this year's increases in US rates. This externally imposed monetary tightening has prompted a downward correction in overinflated asset prices, and should help bring down that part of Hong Kong's inflation which is not due to inherent shortages of land and labour, averting too much medium term damage to Hong Kong's competitiveness. Exports, the traditional engine of growth, have been unimpressive; domestic exports have contracted since early 1993 while growth in re-exports (most of which is to/from China) has continued to decelerate over the past year despite a strong acceleration in China's exports. This may in part reflect capacity constraints in Hong Kong, which the authorities are addressing with substantial infrastructure projects.

HONG KONG: MONEY MARKET AND BALANCE OF PAYMENTS



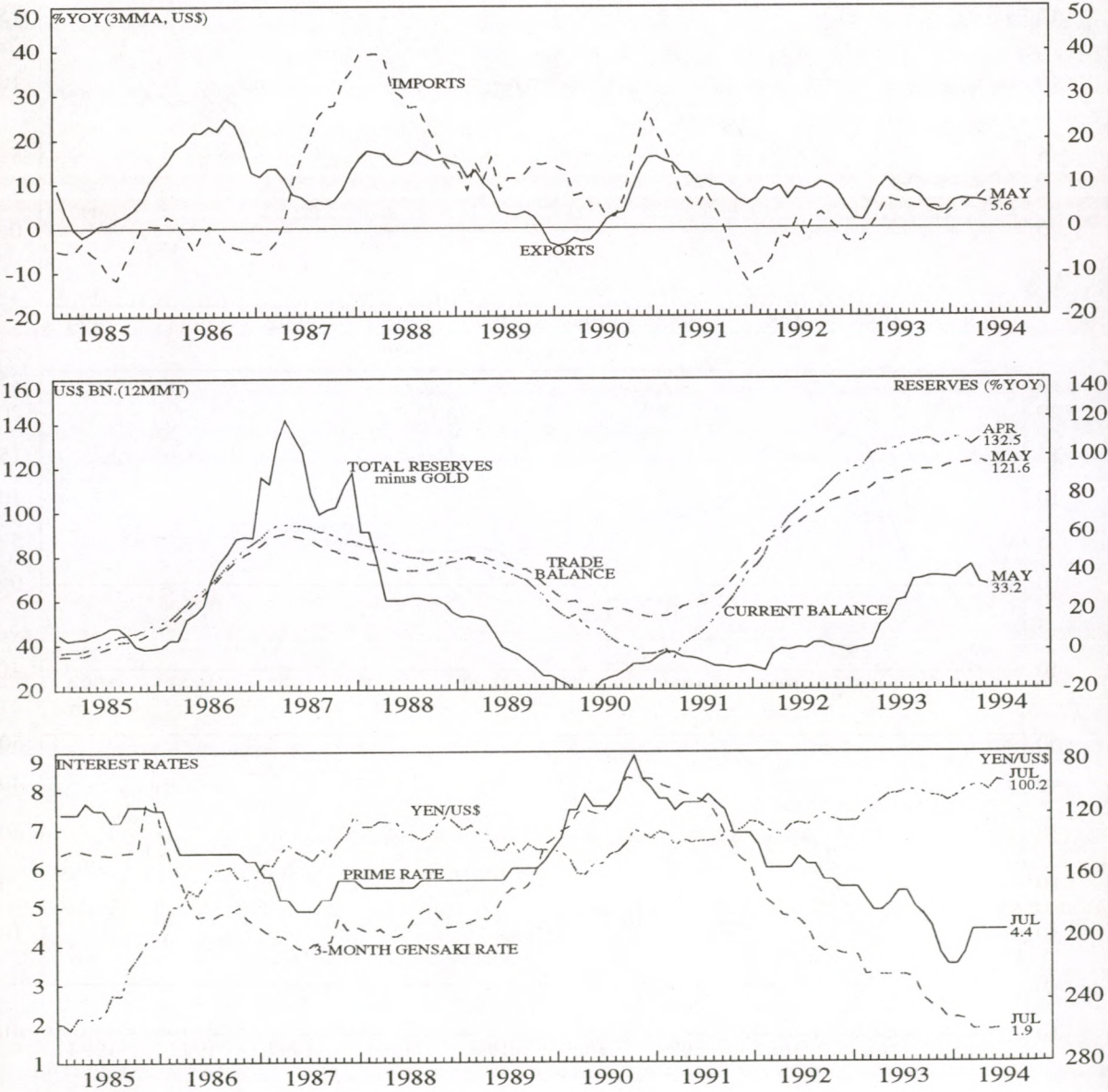
HONG KONG: MONEY, OUTPUT, GOODS AND ASSET PRICES



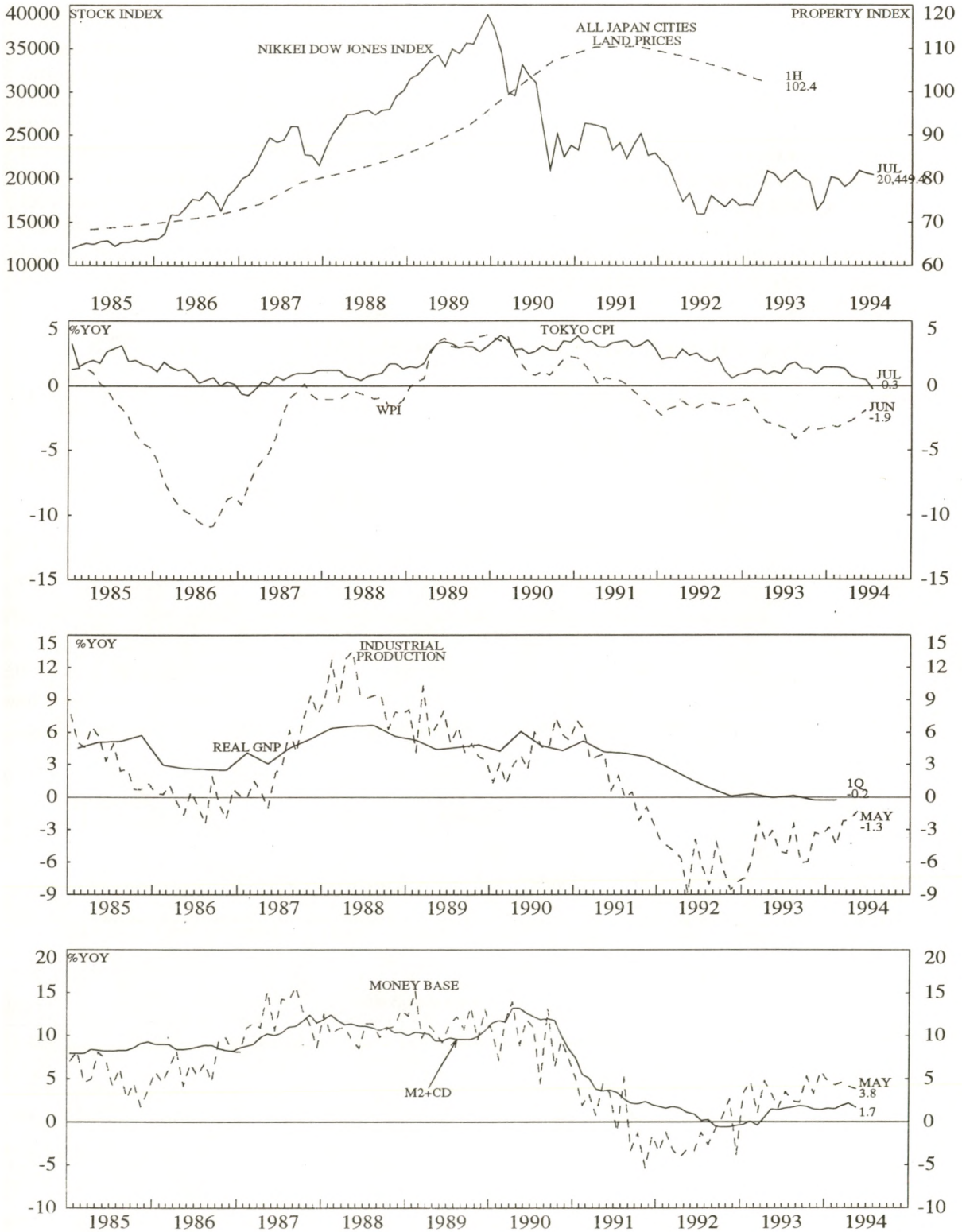
JAPAN: TENTATIVE SIGNS OF RECOVERY

The economy may now have commenced the deflationary recovery described in the last AMM (March-April 1994). Notwithstanding the June trade figures, the trade surplus appears to have stabilised, as import growth has overtaken export growth dented by the recent strength of the yen, and industrial production is falling at a much less dramatic rate than in 1992 and 1993. The money base has been growing faster than M2+CDs since January 1993, and should facilitate stronger money growth when real interest rates become low enough to stimulate credit demand. Although real interest rates have fallen further over the past year as official rates have been cut and as the deflation of wholesale prices has moderated, the difference between the prime rate of 4.4% and wholesale price inflation of -1.9% still looks too high to kick-start domestic demand in the near term.

JAPAN: MONEY MARKET AND BALANCE OF PAYMENTS



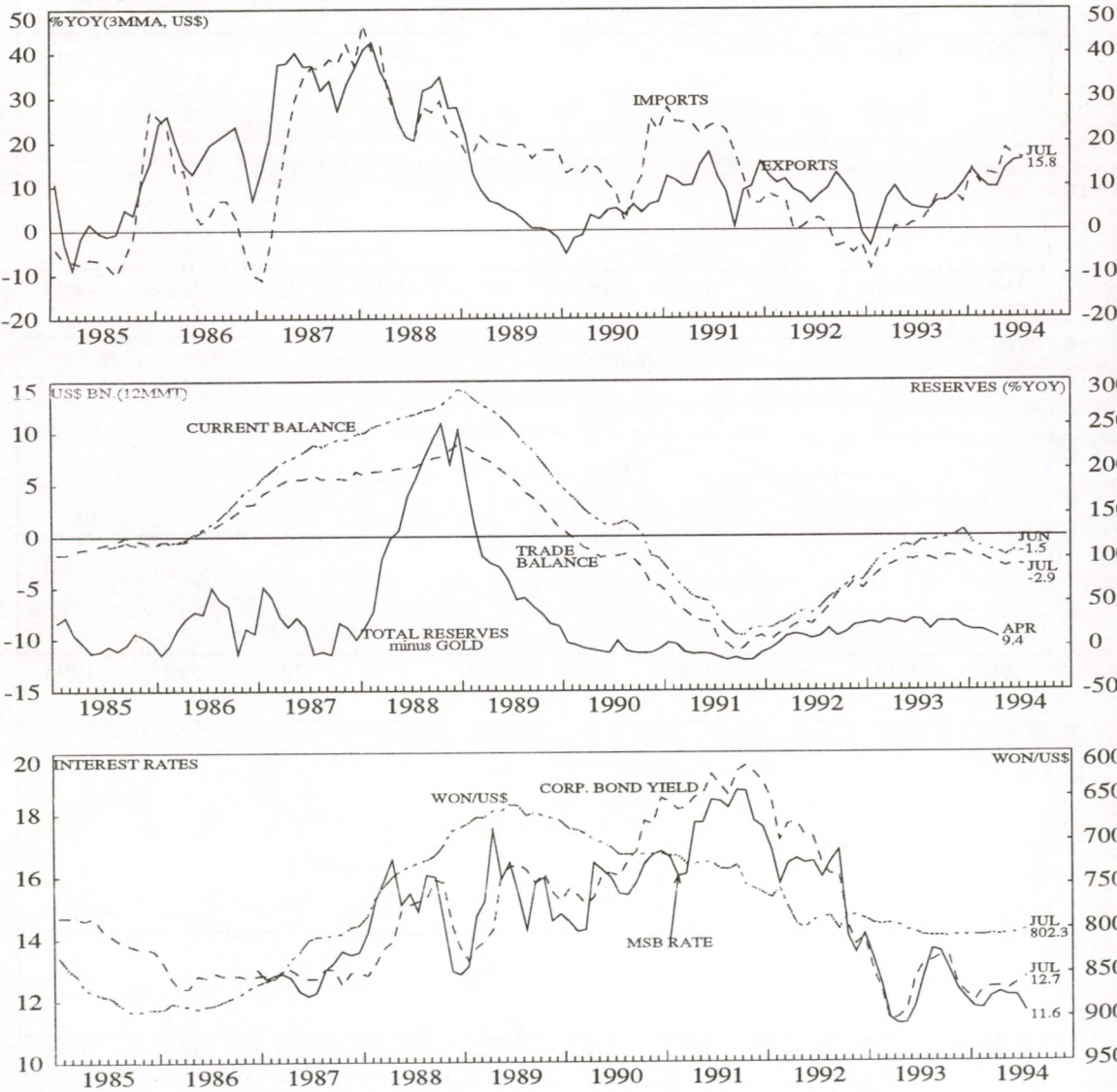
JAPAN: MONEY, OUTPUT, GOODS AND ASSET PRICES



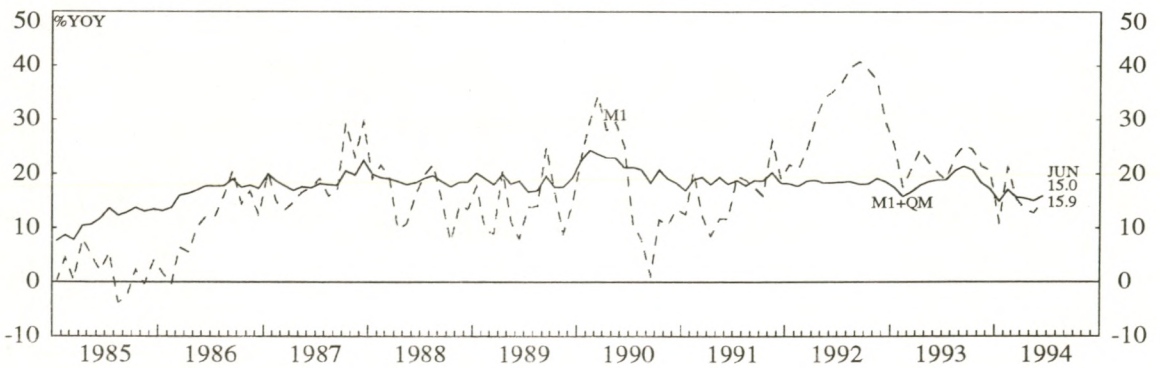
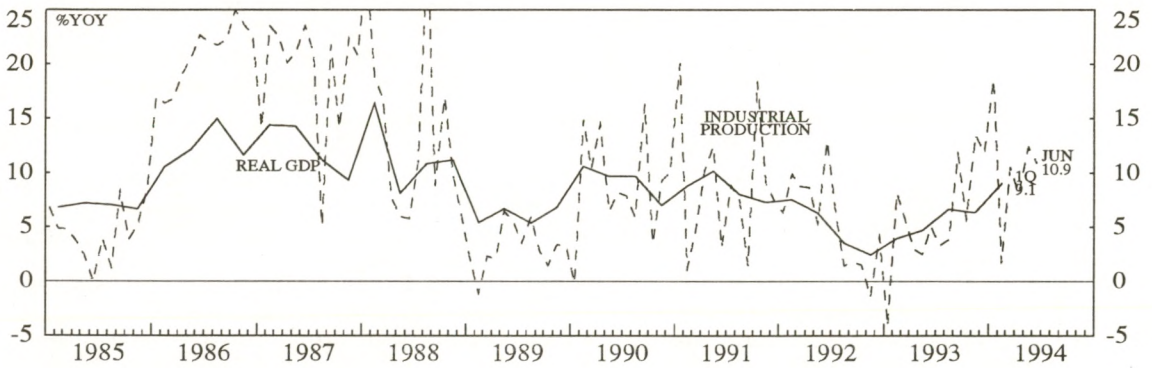
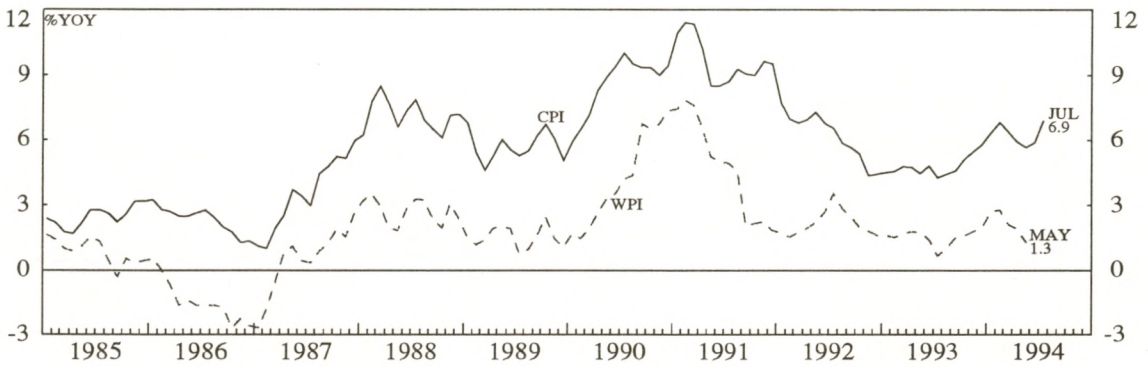
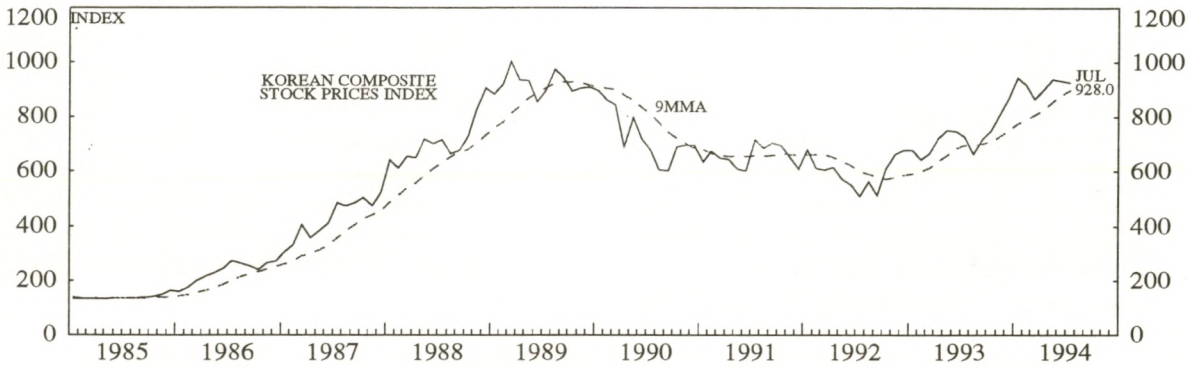
KOREA: RECOVERY GATHERS PACE

Since taking office, Kim Young Sam's administration has given the Korean economy substantial fiscal and monetary stimuli (see article on p.11), propelling the economy onto a strong recovery. Although the risks of overheating and inflationary pressures are of some concern, the main parameters of economic policy (14-17% M2 growth target and a fiscal deficit of around 1/2% of GDP) for 1994-95 have been fixed and are unlikely to be changed; and any attempt by the central bank to tighten monetary conditions look set to be reversed if perceived to threaten the pace of economic recovery. A pick-up in loan demand is now putting upward pressure on corporate bond yields and lending rates, but further financial sector reform and market opening should make the financial sector more competitive and reduce intermediation costs. Meanwhile, the remaining exchange controls on the capital account makes Korea's monetary conditions less susceptible to changes in international interest rates.

KOREA: MONEY MARKET AND BALANCE OF PAYMENTS



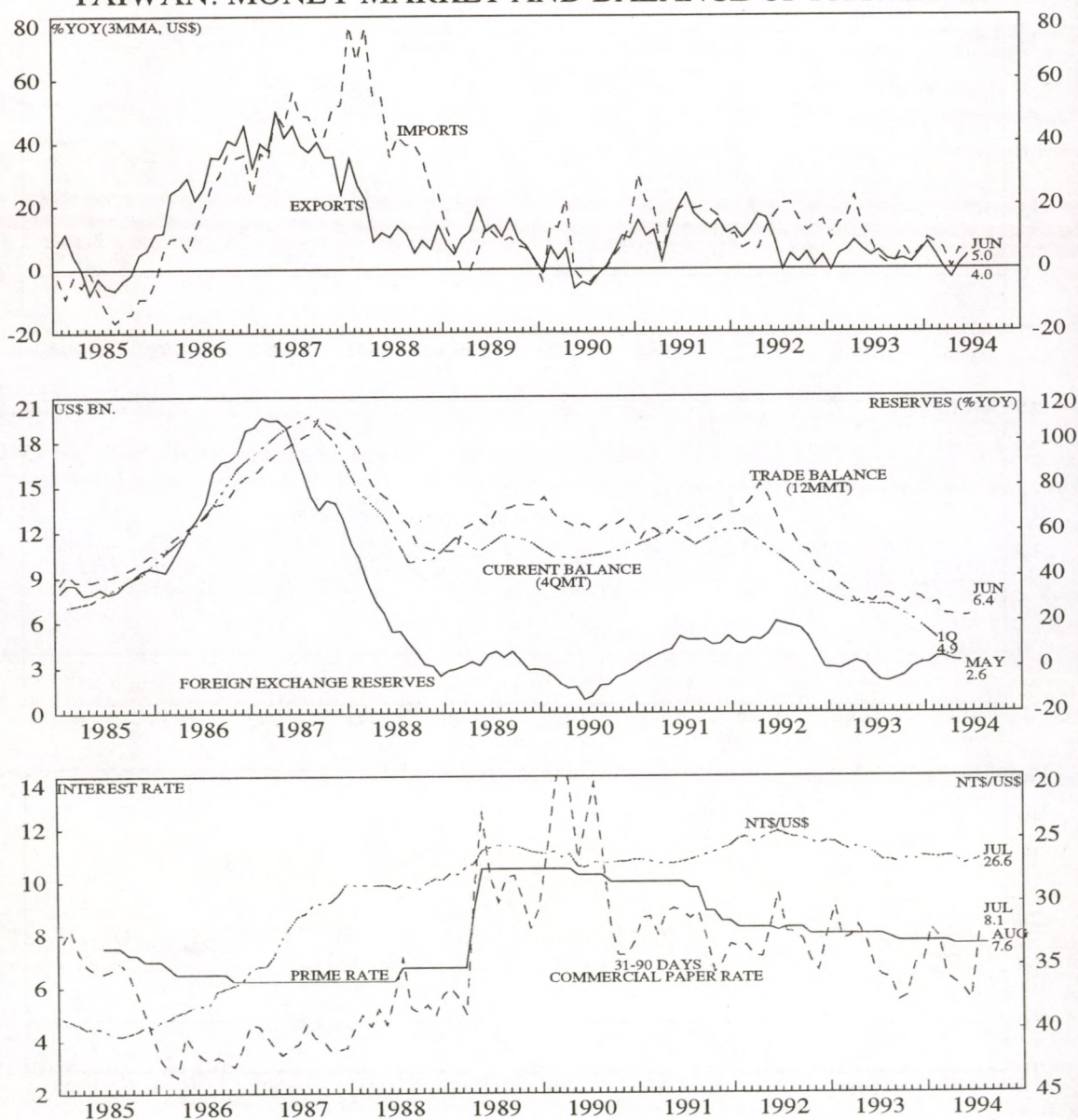
KOREA: MONEY, OUTPUT, GOODS AND ASSET PRICES



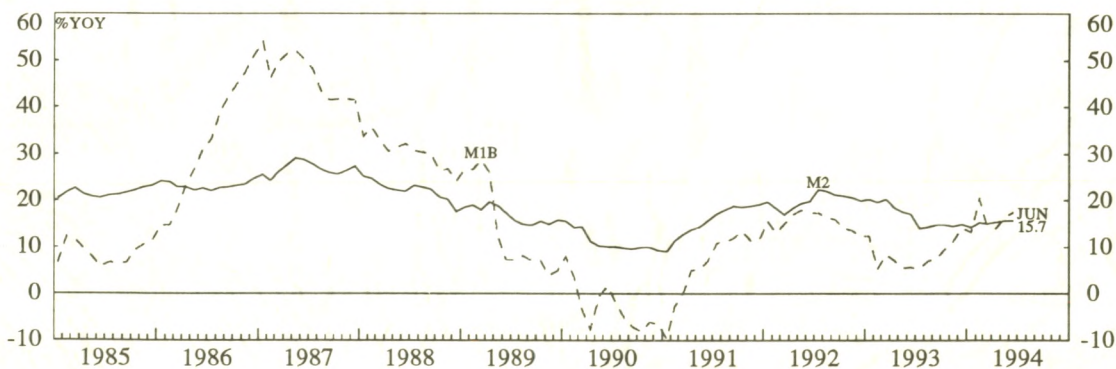
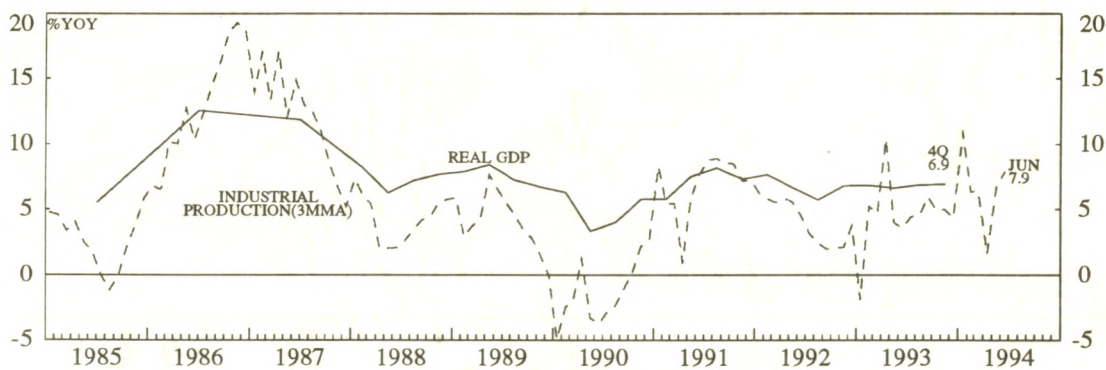
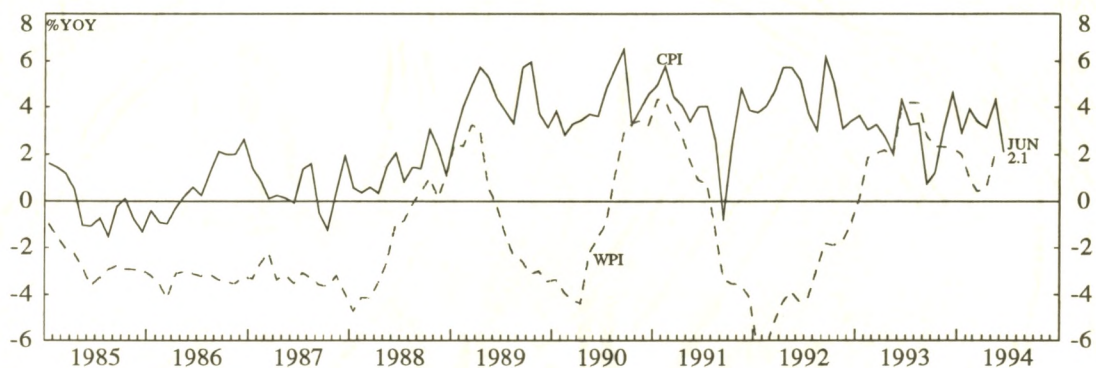
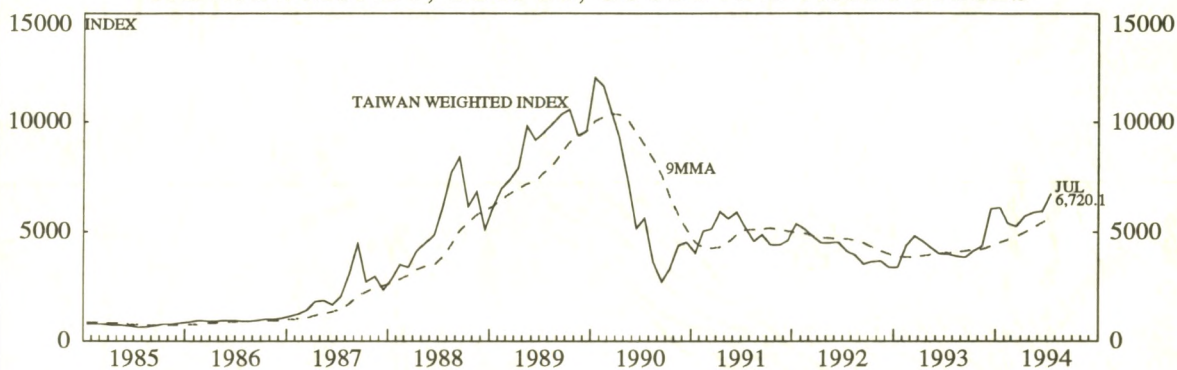
TAIWAN: AWAITING AN EXPORT BOOM

Since the deceleration in exports in 1992, Taiwan has had a benign monetary environment conducive to stable growth with low and modestly declining inflation. Ambitious infrastructure programmes announced to stimulate growth have so far been implemented at a cautious pace. Exports have been sluggish by historical standards, as Taiwan has lost competitiveness in labour intensive manufacturing and embarked upon a process of structural change towards more skills and capital intensive manufacturing and services. Nevertheless in the absence of any stimulative exchange rate depreciation a broad based recovery in the OECD could provide the impetus for modest export led growth with positive implications for future profits and equity prices.

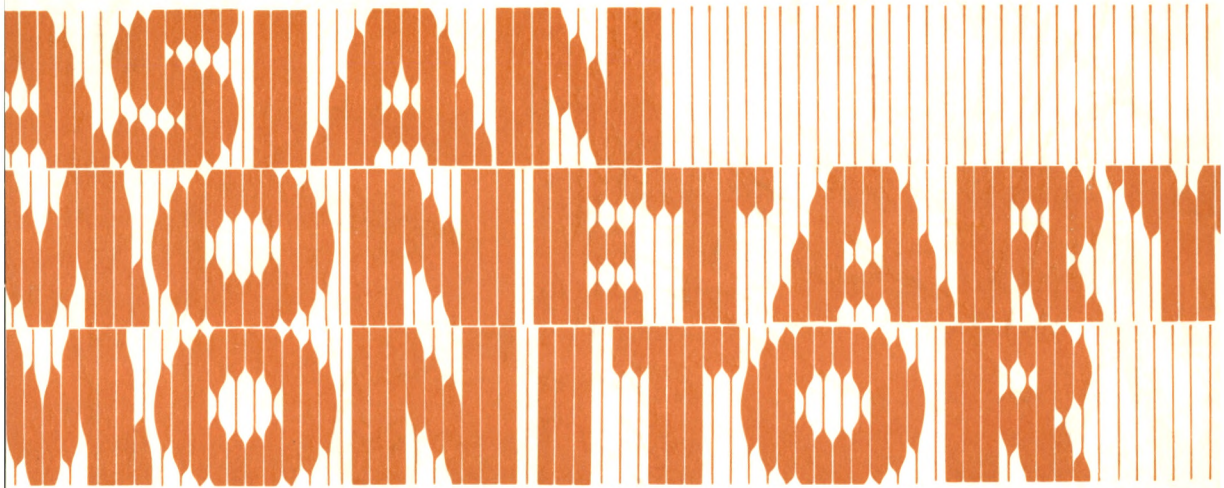
TAIWAN: MONEY MARKET AND BALANCE OF PAYMENTS



TAIWAN: MONEY, OUTPUT, GOODS AND ASSET PRICES







CONTENTS

	Page
REGIONAL SURVEY	
Exchange Rate Regimes and Monetary Stability in Asia by John Greenwood	1
INDONESIA	
Adjustment to Higher Global Demand for Funds by Philip Wyatt	10
MALAYSIA	
A Monetary Hangover by Jakob Lund	21
ECONOMIC CAPSULES	
Australia: Change in Composition of Growth Ahead	PTW 32
India: Expansion Continues Aided by Foreign Capital	PTW 34
New Zealand: Strong Growth with Monetary and Fiscal Prudence	PTW 36
Pakistan: Poor External Balance Constrains Domestic Economy	PTW 38
Sri Lanka: Stronger Growth Ahead	PTW 40





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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price US\$300 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to the Editor, Asian Monetary Monitor Ltd., GPO Box 12964, Hong Kong.

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ASIAN MONETARY MONITOR

July-August 1994

Vol. 18 No.4

REGIONAL SURVEY EXCHANGE RATE REGIMES AND MONETARY STABILITY IN ASIA

Introduction

There are two broad theoretical approaches to achieving monetary and price stability. The first approach is to pursue price stability by means of an intermediate quantitative target such as the monetary base or a broad or narrow money aggregate, on the basis of a functionally stable relationship between the chosen aggregate and the real or nominal GDP. The second approach is to pursue price stability by fixing the currency to an external currency such as the US dollar and allowing the balance of payments at the chosen exchange rate to determine the quantity of money which brings about parity of traded good prices with the country to whose currency the home currency is pegged. Two distinct subsets of the latter approach to be discussed below are : (i) pegged or managed exchange rates under a central bank, and (ii) currency board arrangements with permanently fixed exchange rates or unified currency systems.

Over the past five decades since the creation of the Bretton Woods system, the smaller East Asian countries have predominantly pursued the second route to monetary and price stability, with most of them maintaining central banks and pegged rates, and only a few having currency board arrangements. However, Japan is an exception, having progressively abandoned fixed rates between August 1971 and February 1973, and having pursued monetary targets for much of the period between July 1974 and September 1985 (the Plaza Agreement) or February 1987 (The Louvre Accord). From that time onwards Japanese monetary targeting has been derailed by the obligation to maintain exchange rate targets or bands for the yen-dollar rate as agreed with other members of the G-7.

This article will assess the experience of the Asian economies in managing the internal and external values of their currencies. Japan will be treated first as a clear example of a country which shifted from an external anchor (pegging the currency at yen 360 per US dollar from 1949 to 1971) to a quantitative target for the money supply (normally a quarterly target for year-to-year growth of M2 plus CDs). The lessons of this experience are very clear, but they apply only to large economies. Some implications of this analysis will be spelled out for China which is likely to follow -- in broad terms -- the trail blazed by Japan in the period 1949-71. Finally, the smaller East Asian economies will be treated as a separate group, and some attempt will be made to assess the optimal approach to currency management as a means of achieving price stability with or without capital controls.

Pegged Versus Floating Exchange Rates: The Experience of Japan

Between April 1949 and August 1971 the yen-dollar exchange rate was pegged at yen 360 per US dollar. Throughout most of this period the Japanese business cycle resembled an amplified version of the US business cycle. Because Japan's real GNP growth rate was substantially greater (8% p.a. versus 3% p.a. for the US) the amplitude of fluctuation was greater. This was true for both nominal and real magnitudes. Using the Japanese WPI as a measure of Japan's traded goods prices and the US WPI as a measure of US Asian Monetary Monitor

traded goods prices, the pegged exchange rate operated as theory would predict to keep price levels in line: the Japanese WPI rose at an annual rate of 1.6% p.a. while the US WPI rose at an average rate of 1.7% p.a. Reflecting Japan's more rapid growth of productivity, non-traded goods prices rose more rapidly than US traded goods prices. Thus the Japanese CPI rose at 4.4% p.a. over the 21-year period while the US CPI rose at 2.3% p.a.

If the Bretton Woods mechanism worked so well over so much of the period, why did it eventually break down? The answer points to two fundamental flaws in pegged exchange rate systems. First, rising inflation in the late 1960s in the anchor country (the US) threatened to generate much higher inflation in the satellite country (Japan). Second, from 1965 onwards as the Japanese authorities gradually freed up capital controls they simultaneously began sterilising the impact of those capital flows in order to prevent the rising inflation in the US having too much effect on Japan. (See Suzuki 1980: 190-5.) As a result, by 1969-70 Japanese and US traded goods prices had started to diverge sharply: the US WPI was rising while the Japanese WPI was actually falling. An obvious symptom of this was the growing Japanese trade and current account surplus. Japan's surpluses were a major factor in President Nixon's decision to close the gold window in August 1971, which ultimately led to the demise of the Bretton Woods system.

By contrast, the period from 1974 to 1985 represents a complete switch in policy and in results. The Bank of Japan (BOJ) began to pursue quantitative targets for M2 plus CDs from July 1974. Within two or three years the BOJ had achieved greater stability of economic growth and insulation from the US business cycle, and progressively succeeded in lowering the inflation rate. At the same time the yen was allowed to float more freely, and more steps were taken to liberalise capital movements. The results, documented in Tables 1 and 2 show that the economy grew more steadily -- despite the second oil shock in 1979-80 -- and the inflation rate remained low and stable. Unfortunately for Japan this golden era was terminated by the series of currency agreements which it entered into with the US and other G-7 members from September 1985 onwards. The obligation to peg the yen within specified target bands played havoc with domestic monetary management, and by late 1987 Japan's monetary growth had accelerated from 8% p.a. to 12% p.a. This ushered in the infamous bubble years when financial asset prices and real estate prices rose by leaps and bounds, and created the basis for the long recession and the serious financial shake-out which is still continuing in Japan today.

The lessons of these two contrasting experiments initially with a pegged exchange rate and then with a floating rate are clear. First, if a large or fast-growing economy (like Japan in the 1950s and 1960s) is to operate a pegged exchange rate, (i) the monetary policy of the anchor country must be kept stable, and (ii) in the absence of capital controls sterilisation of capital flows will ultimately undermine the ability of the authorities to maintain the pegged exchange rate. Second, if a large, open economy pursues monetary targets with the purpose of achieving domestic price stability, this cannot be combined with the attainment of exchange rate targets or zones. In other words, the exchange rate must be allowed to float freely, capital controls must be eliminated, and sterilisation operations cannot be relied on to counteract capital flows.

The experience of Japan under rigidly pegged exchange rates in the 1950s and 1960s offers some useful pointers for China in the next two or three decades. China is now enjoying the same kind of rapid growth experience that Japan experienced in the period 1949-71, except that China appears to be growing even more rapidly on average, probably because central planning, state ownership and price controls in the period to 1980 held back China's economic performance for thirty years. Moreover, China is pursuing a pegged

TABLE 1**THE IMPACT OF LOWER MONETARY GROWTH IN JAPAN
ON GNP AND INFLATION**Average Rates of Growth (% per annum)

	<u>1970-74</u>	<u>1974-78</u>	<u>1978-83</u>
Money Supply	20.2	12.8	9.0
Nominal GNP	16.4	10.4	6.0
Real GNP	4.9	4.9	4.0
GNP Deflator	11.2	5.3	1.8

Notes: 1. Money supply is quarterly averages of month-end data for M2 to April 1979, M2+CDs from May 1979, seasonally adjusted at annualised rates.

2. Nominal and real GNP are quarterly data, seasonally adjusted at annual rates.

3. Data for money supply are from June to June for each period; data for GNP and for the GNP deflator are for six months later, i.e., December to December in each case.

TABLE 2**THE IMPACT OF STEADIER MONETARY GROWTH IN JAPAN
ON GNP AND INFLATION**Standard Deviations of Quarterly Data

	<u>1970-74</u>	<u>1974-78</u>	<u>1978-83</u>
Money Supply	5.4	2.6	3.0
Nominal GNP	7.6	3.7	2.6
Real GNP	7.1	3.3	1.8
GNP Deflator	7.5	1.5	2.3

Notes: Data as in Table 1.

exchange rate policy similar to that followed by Japan in the pre-1971 era. The main differences are that (1) China has shown a willingness to devalue the currency from time to time in contrast to Japan's ability to maintain the yen 360 per US dollar peg unchanged, (2) China's financial markets are much more primitive so the People's Bank of China (PBOC), i.e., the central bank's ability to counteract external shocks may be much more limited, and (3) the extent of China's foreign exchange controls today is much greater than Japan's was in the 1960s. (For a full discussion of the comparison of Japan and China under pegged exchange rates see Greenwood 1993 pp. 1-12.)

While there is an argument to be made for a small open economy with a large trade sector to maintain a fixed exchange rate (e.g., Hong Kong) on the grounds that, since so much economic activity is externally determined, the demand for money is unlikely to be functionally stable, for a large and much less open economy such as China there is a stronger case for pursuing the alternative route to monetary stability (i.e., control of the quantity of money while allowing the exchange rate to float). The problem for China in pursuing the latter strategy is that Chinese financial markets and PBOC's instruments of monetary control are so primitive as to make such a policy choice virtually impracticable. It therefore seems likely that China will maintain a rigid pegged exchange rate, though there may be occasional devaluations (or possibly revaluations). If China devalues its currency against the US dollar on several occasions then a more apt comparison (than Japan) might be with South Korea in the period 1955-75 when Korean experience could be summarised as a series of episodes of "grow-inflate-devalue". In either case, China's business cycle is likely to be characterised by the same kind of roller-coaster experience witnessed by Japan under Bretton Woods between 1949 and 1971.

The Smaller Asian Economies: From Rigid Pegs to Managed Pegged Rates

The experience of the smaller East Asian economies (defined here to include South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Thailand, Indonesia and the Philippines) is harder to summarise. None of them has adopted a monetary target with a truly floating exchange rate for any sustained period of time, though at times some have paid lip service to monetary targets and at other times some have allowed their currencies to float freely. However, as a broad generalisation in the first two and a half decades of Bretton Woods, their exchange rates were rigidly pegged to the US dollar, but in some countries such as Indonesia, South Korea and the Philippines there were frequent devaluations and high inflation. With the exception of Hong Kong none enjoyed full convertibility in the sense of freedom from current and capital account controls. Since the early 1970s and the breakup of the Bretton Woods system among the major countries, the smaller East Asian economies have progressively moved away from rigidly pegged rates to some form of managed exchange rate and this has been accompanied by some relaxation of foreign exchange controls.

Hong Kong is an exception to this trend, having adopted a floating exchange rate in the period 1974-83 with no accompanying monetary control mechanism, an experiment which ended in failure when the Hong Kong dollar collapsed in September 1983. From October 1983 Hong Kong has re-introduced a traditional currency board arrangement with the Hong Kong dollar rigidly fixed to the US dollar and, consistent with its *laissez-faire* philosophy and practices, Hong Kong has maintained full convertibility with no controls on capital or current account transactions. However, as in other countries, inflows and outflows of capital have at times been viewed as destabilising by the authorities, and in response they have gradually introduced more instruments of monetary control, such as open market operations in bills and bonds issued by the Hong Kong Monetary Authority (HKMA),

July-August 1994

TABLE 3

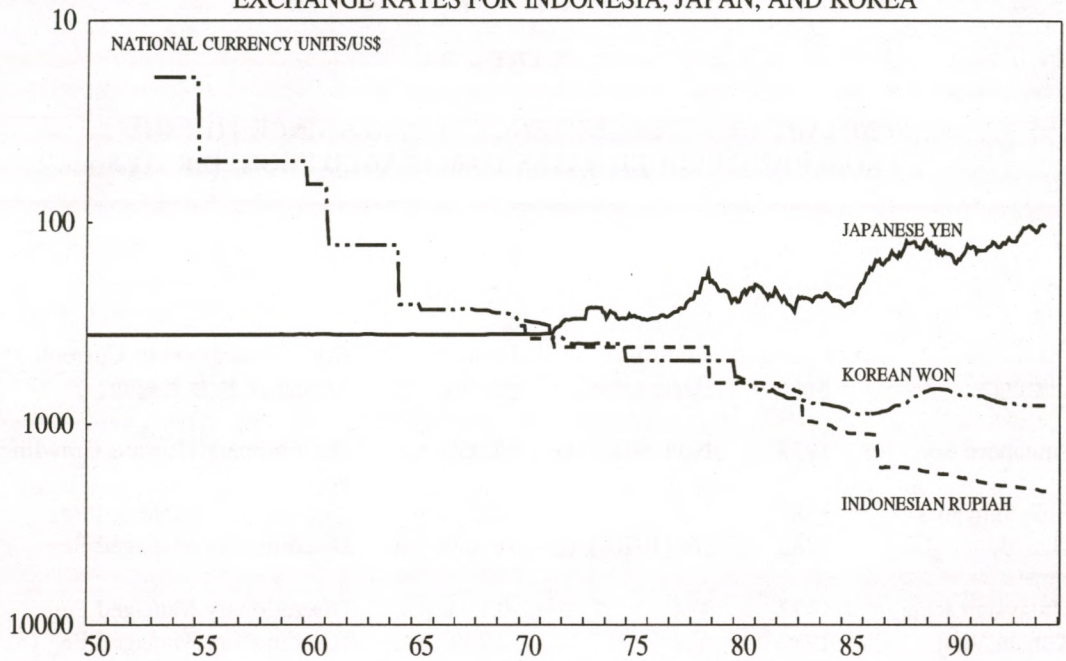
**SUMMARY OF ASIAN CURRENCY REGIMES SINCE THE SHIFT
FROM RIGID PEGGED RATES TO MANAGED PEGGED RATES**

<u>Currency</u>	<u>Date of Shift To Managed Rate</u>	<u>Exchange Controls [Date Lifted]</u>	<u>% p.a. Appreciation or Depreciation Against US\$</u>	<u>Brief Description of Current Exchange Rate Regime</u>
Singapore \$	1977	No [1978], (1)	+2.95% p.a.	Discretionary Upward Crawling Peg
New Taiwan \$	1981	Yes	+2.21% p.a.	Discretionary Managed Peg
Thai Baht	1985	No [1970s], (2)	+0.88% p.a.	Discretionary Managed Peg
Malaysian Ringgit	1977	Yes	-0.19% p.a.	Discretionary Managed Peg
Korean Won	1980	Yes	-2.26% p.a.	Discretionary Managed Peg (3)
Indonesian Rupiah	1981	No [1970s]	-8.30% p.a.	Discretionary Crawling Peg (4)
Philippine Peso	1981	No [1992]	-8.94% p.a.	Discretionary Managed Peg (5)

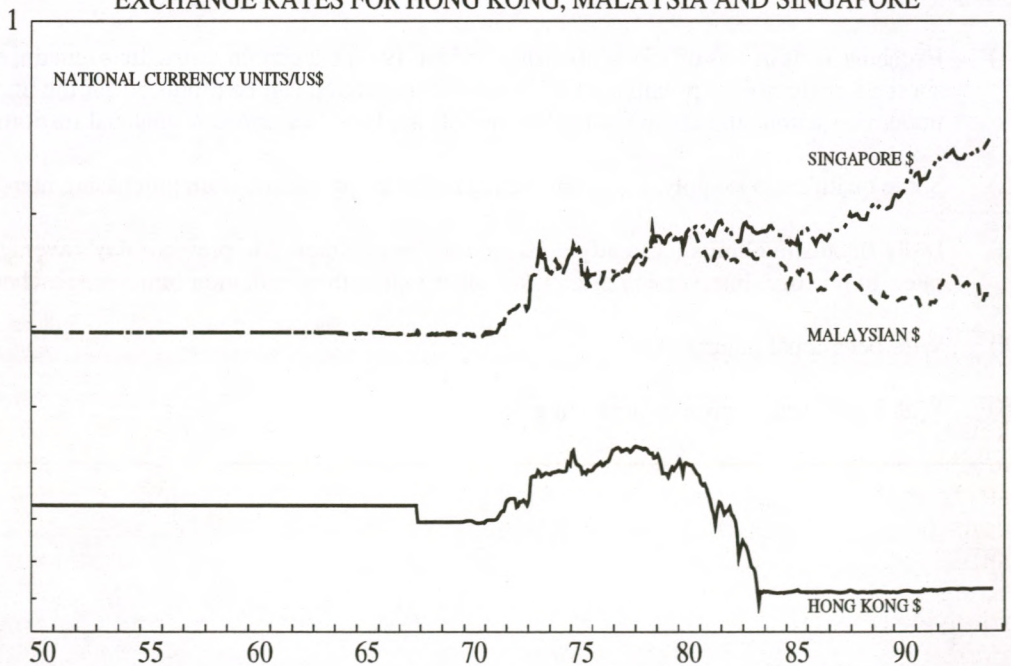
Notes:

- (1) Exchange control was officially abolished in June 1978, but certain restrictions remain, e.g., long or short S\$ positions are prohibited unless the documentation can be produced for the underlying trade transaction, and certain portfolio controls apply to Singaporean financial institutions.
- (2) Some qualifications apply, e.g., Thai mutual funds are prohibited from purchasing non-Thai assets.
- (3) Daily fluctuation limits (currently $\pm 1\%$) are set with reference to previous day's average exchange rate. In practice, intervention often takes place before the fluctuation limits are reached.
- (4) With occasional adjustments.
- (5) With some recent episodes of floating.

OVERVIEW: CHART 1
EXCHANGE RATES FOR INDONESIA, JAPAN, AND KOREA

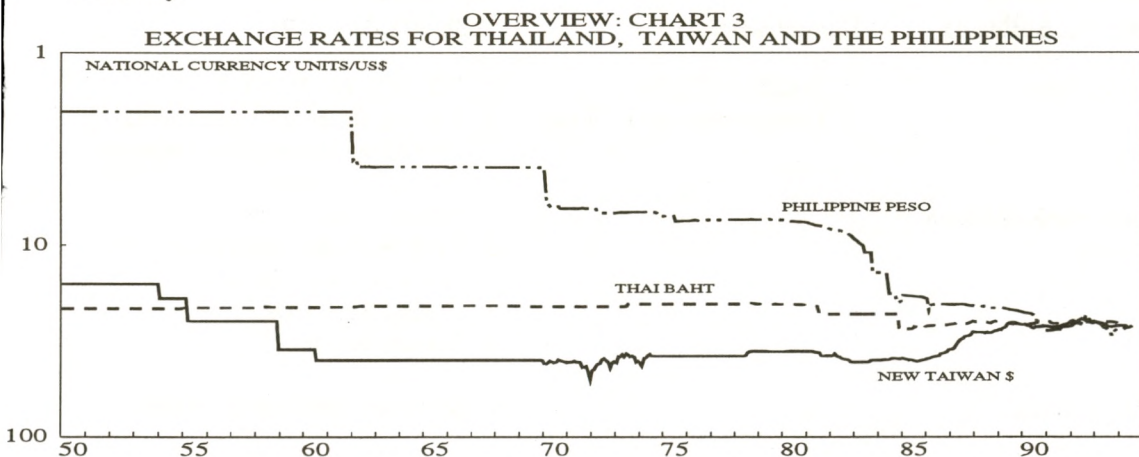


OVERVIEW: CHART 2
EXCHANGE RATES FOR HONG KONG, MALAYSIA AND SINGAPORE



a variable reserve requirement imposed on the major note issuing bank, and a liquidity adjustment facility or window, known as LAF. As a result, the Hong Kong currency board is no longer a textbook example of a passive agency issuing and redeeming notes on demand but much more akin to an activist central bank. The key distinctions between the HKMA and other central banks in East Asia are its commitments (1) to issue and redeem bank notes at a fixed price (HK\$7.80 per US\$) against US dollars, which thus enables the HKMA to maintain a foreign currency reserve in excess of 100% of its liabilities, and (2) to maintain freedom from capital controls -- an undertaking which is specifically written into the Basic Law, the constitution which will guide Hong Kong after its transfer to Chinese sovereignty on July 1, 1997.

Turning to the other seven currencies among the smaller Asian countries, the most striking development since the break up in the early 1970s of the Bretton Woods system of rigidly pegged currencies has been their progressive shift to managed currency regimes, as illustrated in Charts 1-3. With the exception of the Hong Kong dollar discussed above, all the other seven Asian currencies now operate a discretionary, managed currency regime whereas prior to 1971 they were all rigidly pegged to the US dollar. Table 3 summarises the experience of these currencies since they shifted to managed rate regimes. In the remainder of this section I shall discuss the interrelation between the new currency management regimes and (i) the presence or absence of foreign exchange controls, as well as (ii) actions taken by the central banks to deal with allegedly destabilising inflows or outflows of currency.



In the first three decades of BrettonWoods (1944-74), the prevalence of rigid rates among major countries, the relatively underdeveloped state of international telecommunications, and extensive foreign exchange controls meant that it was relatively easy for Asian governments to keep pegged rates under control. Their domestic money and credit markets were by and large insulated or compartmentalised from international capital flows, and arbitrage between their money markets and those of the major countries was negligible or strictly regulated. As capital controls have been eased in the two decades since 1974 these countries have become increasingly exposed to inflows and outflows of capital as well as subject to the activities of international currency arbitrageurs. Rather than adopt the Hong Kong solution of permanently fixed exchange rates combined with complete abolition of foreign exchange and other capital controls, Asian central banks and governments have preferred to manage both domestic liquidity and capital flows by means of sterilisation operations, or occasionally (e.g., as Bank Negara Malaysia did in January-April 1994) by reimposition of foreign exchange control measures.

One of the interesting features of sterilisation operations by Asian central banks has been their use of central bank liabilities rather than assets to offset the impact of inflows and outflows of capital on the domestic money and credit aggregates. Classic, orthodox sterilisation operations consist of, for example, purchases of foreign currency assets by the central bank, counteracted by the sale of domestic assets (such as T-bills or bonds) to absorb the newly created domestic currency deposits held by the private sector. In the case of Taiwan in 1985, the Central Bank of China virtually exhausted its stock of saleable domestic assets, and from late 1985 onwards began creating new liabilities to absorb excess private sector liquidity. Four main instruments were developed (see Table 4), and by the end of 1986 these amounted to more than twice the size of the traditional monetary base (cash currency issued plus reserve deposits of commercial banks), and were twice the size of M1A, and almost equal to M1B.

TABLE 4
STERILISATION INSTRUMENTS USED BY
EAST ASIAN MONETARY AUTHORITIES, 1970-1994

<u>Central Bank of Monetary Authority</u>	<u>Domestic Assets</u>	<u>Domestic Liabilities of the Central Bank or Monetary Authority</u>
Bank of Japan	1. T-Bills and JGBs 2. Commercial Paper (Tegata)	1. BOJ Bills (1970-72) 2. Variable Reserve Requirements (VRR) on Non-resident Deposits
Central Bank of China (Taiwan)		1. Treasury Bills "B" 2. VRR on Banks' and Postal Savings System Deposits 3. Central Bank CDs 4. Savings Bonds
Bank of Korea		1. Monetary Stabilisation Bonds
Hong Kong Monetary Authority		1. Exchange Fund Bills and Bonds 2. VRR for Hong Kong and Shanghai Bank
Bank Negara Malaysia		1. BNM Bond Issues 2. VRR on Commercial Bank Deposits 3. Money Market Borrowing
Philippines Central Bank (BSP)	1. Sale of T-Bills	1. VRR 2. "Special Series" T-Bills
Bank Indonesia	1. SBPU's (Promissory Notes)	1. SIBs (=BI Certificates)

When a central bank sterilises a capital inflow it is essentially preventing the appropriate adjustment from occurring. The right response to a large inflow (which let's suppose was prompted by a positive short-term interest rate differential) at any given exchange rate is either to let the exchange rate appreciate until the inflow ceases, or allow the full impact of the inflow to be reflected in lower interest rates and faster monetary growth, which will ultimately result in higher asset prices and higher goods and service prices. By sterilising a central bank (a) temporarily maintains the going exchange rate, and (b) prevents any interest rate or quantitative monetary adjustment from occurring. The next result is that further inflows follow because interest rate differentials between the home country and abroad remain unchanged. This is exactly the dilemma faced recently by Bank Negara Malaysia (BNM) and also by the central bank of the Philippines (BSP). It is also precisely the problem faced by European central banks in the ERM and described by Hanke and Walters as the critical "fault line" at the heart of pegged exchange rate mechanisms. Thus, sterilisation is not even a temporary palliative. In the end it is self-defeating because attempts to absorb liquidity (i.e., reduce the money supply) by selling bills, bonds or commercial paper necessarily imply raising local interest rates back to the level which prompted the original capital inflow. Such sales therefore exacerbate the foreign inflows which caused the problem in the first place. To achieve the proper adjustment after sterilisation a larger exchange rate movement may be needed (first upward, then possibly downward) than if the original capital movement had been accommodated by a combination of gradual market-led upward movement of the foreign exchange rate and a mild downward movement in short-term interest rates.

As the small East Asian economies become richer and their financial markets become more sophisticated, there will be greater pressure on policy makers to liberalise both inward and outward capital flows. The more liberal their capital controls, the more closely the local Asian money markets will become integrated with capital markets of the leading financial centers -- New York, London and Tokyo. This means that Asian central bank policy-makers face a fundamental choice: either (1) managed (i.e., pegged) rates with some combination of trade and capital controls and/or sterilisation leading to periodic instability in domestic monetary policy (as in the ERM), or (2) more freely floating foreign exchange rates with no trade and capital controls which will permit more stable domestic monetary policy. As uncomfortable as the latter option might seem in the short-run to policy-makers of the externally-oriented Asian economies, it is surely the better choice over the longer term. Singapore is the only East Asian economy to have come anywhere near this ideal, but there it has been achieved at least in part by the preservation of certain capital and portfolio controls.

SUMMARY AND FORECAST: The Bretton Woods system of pegged rates among central banks only operated well as long as the anchor currency country maintained price stability, and -- at least in many parts of Asia -- its success depended heavily on the existence of distorting trade and capital controls. As those controls are dismantled, the fundamental weaknesses or fault lines of the pegged exchange rate mechanism are being more glaringly exposed. Far from re-inventing Bretton Woods (or the ERM), what Asian monetary systems need is to move either to currency boards on the one side (i.e., permanently fixed rates with no activist central banking functions to counteract the monetary adjustments needed to cope with temporary capital flows), or to greater exchange rate flexibility combined with the lifting of capital controls, abstention from sterilisation operations, and more focus on stable domestic monetary policies.

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INDONESIA

ADJUSTMENT TO HIGHER GLOBAL DEMAND FOR FUNDS

Introduction

Around the time of the US recession, when Japan was just entering its recession (over 1990-91) there was a widely held concern that small (and relatively) open economies like Indonesia, would experience significantly slower economic growth as a result of a decline in export demand and from a slowdown in inward foreign investment. However, while Indonesia (and other parts of South East Asia) did experience some weakness in export demand over 1991-92, this was not sufficient to significantly retard economic growth. This is mainly because the decline in economic growth across the OECD was desynchronised so that the overall decline in OECD demand for S.E.Asian exports has been more subdued than would otherwise have been the case. More significantly, the relatively low and declining interest rates across the OECD from 1992 to 1994 provided the incentive for large international shifts to occur in savings (large inflows of long and short term capital) to Asia (ex-Japan). These inflows, for the most part served to reduce the domestic cost of capital (raising asset prices) and thus provide the impetus required for further economic growth. Hence, rather than exhibit substantial decline, real economic growth in Indonesia (and in S.E. Asia) has remained buoyant (averaging 6.5%) over the early 1990s.

Looking ahead over the next couple of years the issue to be discussed in this article concerns the extent to which the source of the external (balance of payments) influence on the economy switches back from the capital account (as net capital inflows subside) to the current account.

The increase in the global cost of funds as credit demand across the OECD expands will change the current environment (which has prevailed for the last two years). Instead of net capital inflows greatly exceeding existing current account needs and thereby placing upward pressure on the real exchange rate (and asset prices), as domestic demand in Indonesia remains relatively strong, the widening of the investment/savings (import/export) gap will cause asset yields to find a floor and rise later on. The general trend towards current account deterioration coupled with higher global interest rates spells downward pressure on the real exchange rate over the next two years (initially via some nominal depreciation, and later through downward pressure on inflation as support of the Rupiah/US\$ rate emerges as the binding constraint in monetary policy). A worsening current account deficit will need to be serviced by increasingly expensive foreign capital. Thus assuming the current exchange rate policy remains in place (i.e. the downward crawling Rupiah/US\$ rate of around 5-6% p.a., chart 2) local interest rates are set to rise (chart 1).

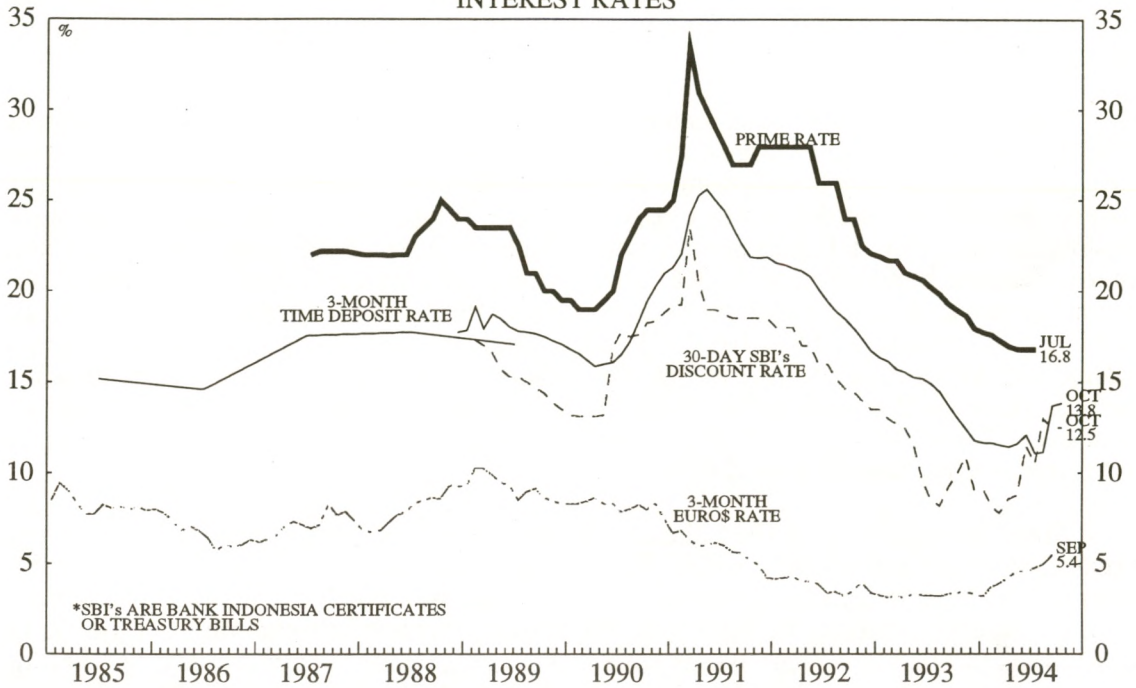
This article proceeds to examine the outlook for the Indonesian economic fundamentals (current account, government balance, and monetary growth) over the next two years against the background of a reversal in global economic conditions. This will then yield a future path for interest rates, asset prices, inflation and the exchange rate.

The External Sector

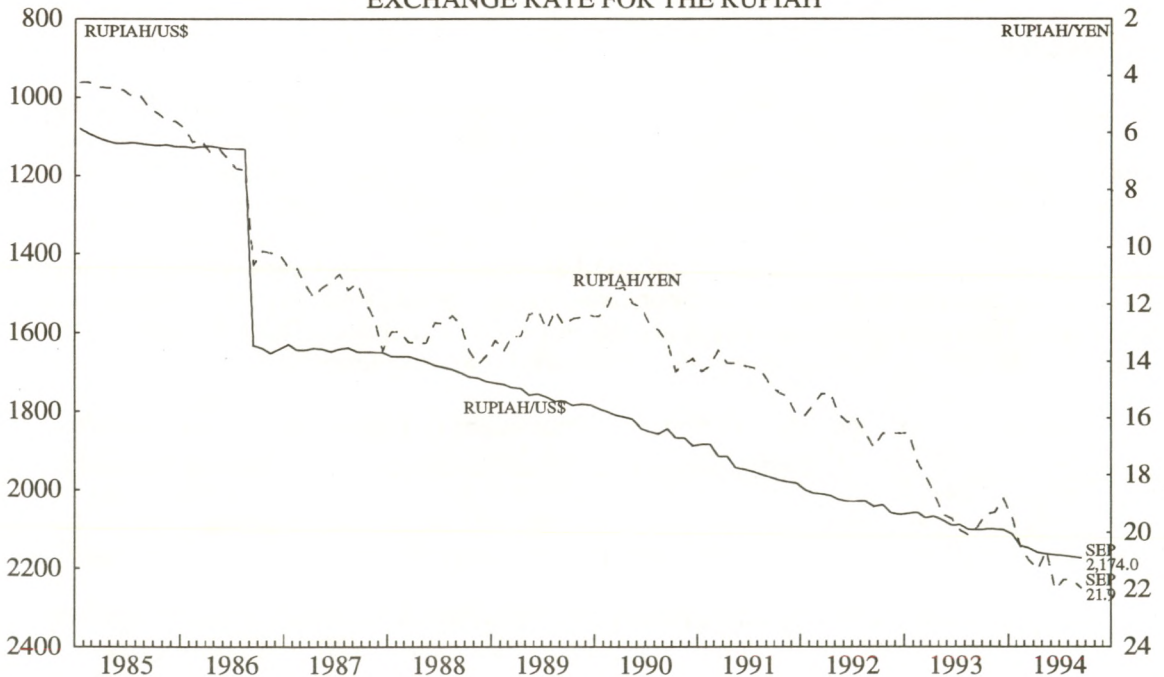
Private Sector Capital Flows

From the start of 1991 to mid 1993 there was a dramatic improvement in the trade and current account balances and, from 1992 onwards, Indonesia has been in receipt of

INDONESIA: CHART 1
INTEREST RATES



INDONESIA: CHART 2
EXCHANGE RATE FOR THE RUPIAH



substantial quantities of portfolio investment (chart 3). In operating its downward crawling Rupiah/US\$ exchange rate the central bank, Bank Indonesia (BI) saw its stock of foreign exchange reserves accumulate from around US\$11bn at the end of 1991 to US\$19.7bn at the start of 1994.

Largely driven by the gains in the domestic equity and international debt markets in 1993, a growing number of large corporations began to finance their domestic operations through foreign (mainly US\$ denominated) bond and CD issues (most guaranteed by the government which has a debt rating of BBB by S&P). A typical example might be the major Indonesian blue chip: PT Indorayon Utama which, in October 1993 issued a 7 year fixed interest Yankee bond offering 9.13%. These capital inflows continued to contribute to a rise in the stock of foreign exchange reserves way after the trade surplus reached its peak and began to decline early in 1993. Although Bank Indonesia sterilised its foreign exchange intervention (see AMM vol 18 No.1) this created a very easy monetary environment in the sense that short term (30 day money market) interest rates were driven down from over 17% at the start of 1992 to around 9% by the end of 1993. Longer term deposit and prime lending rates followed suit.

Since the beginning of 1994, the rises in short term U.S. interest rates have prompted a reassessment of inflationary expectations in the U.S., leading to higher long term US\$ bond yields. This, in turn has raised the yield on this asset which can be used as a benchmark for equity valuations in Indonesia. As a result corporations planning to raise (long term) funds through new share issues have had to compete more aggressively than before and offer higher equity yields. In addition the entrenched deterioration in the current account deficit caused the Rupiah/US\$ rate to weaken towards mid 1994. Bank Indonesia stepped in, this time to support the exchange rate (again sterilising its foreign exchange intervention) although it could not avoid tightening up credit conditions in the interbank money market and short term interest rates began to rise.

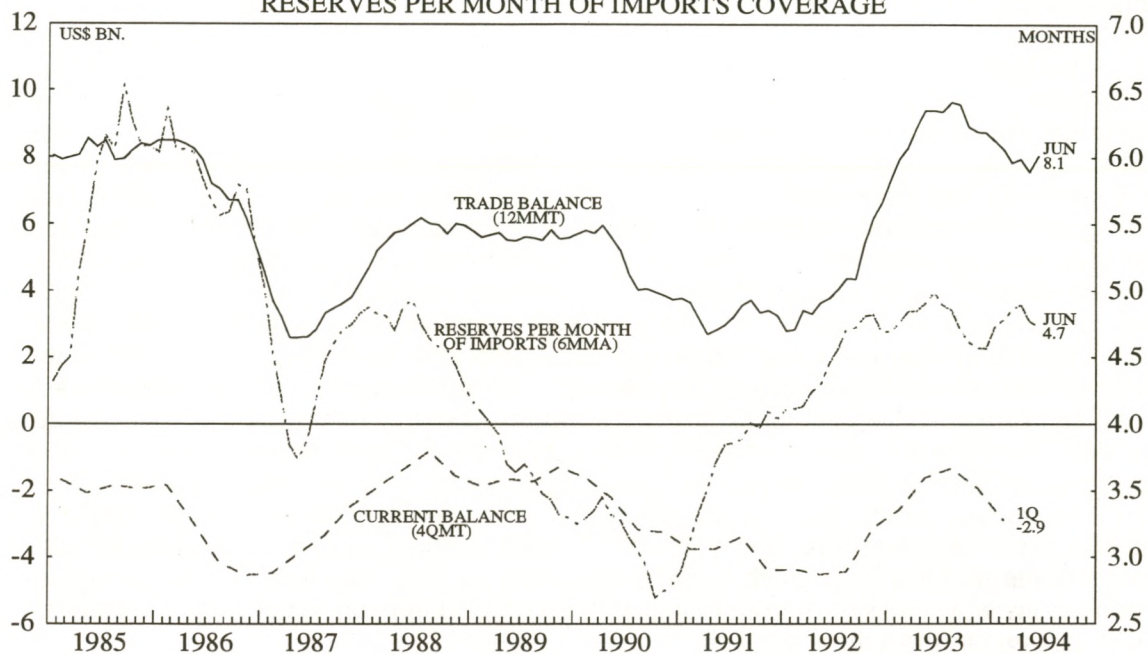
The Trade Balance

Since mid-1993 there has been a deterioration in Indonesia's trade balance. This was mainly due to a deceleration in export growth over this time (charts 4 and 5). Non-oil exports (approximately 70 % of the total) have slowed as a result of a collapse in other commodity prices over 1993 (rubber, plywood, copper, palm oil and pulp account for approximately 47 % of non-oil exports by value). However over the first half of 1994 the recovery in some of these prices has stimulated an upturn in non-oil export growth (chart 4). This general trend is likely to continue as economic growth gathers steam across the OECD area. However plywood prices, are the important exception. They will likely stay weak while the supply from other sources (Malaysia) remains plentiful.

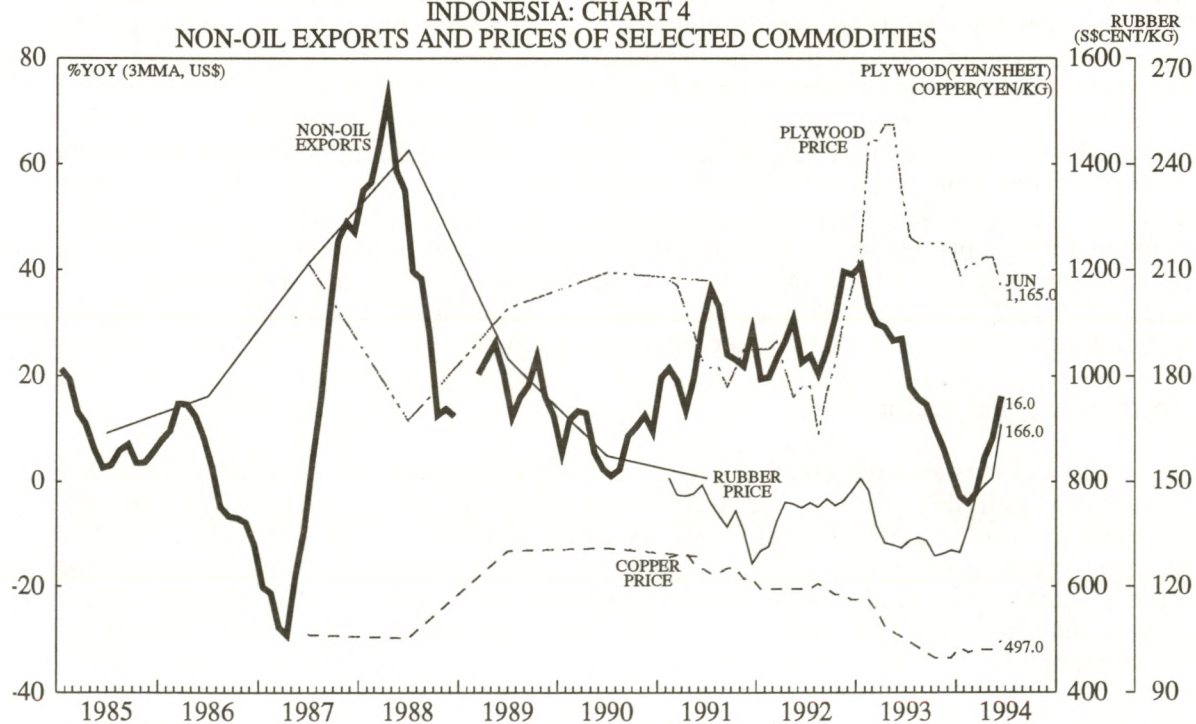
Traditionally, oil has been an important component of Indonesian exports, however there has been a decline in this area of exports from 56% of the total in 1986 to around 30% today. Nevertheless, despite this trend, oil continues to be a significant contributor to export revenues. Consequently, overall export growth will receive some boost from further revival in international oil prices in the coming year (chart 5).

Textiles exports have still not recovered from their sharp deceleration of around 50% in the second half of 1993. In the months ahead textiles exports (20% of non-oil exports) may recover as the current global shortage of cotton motivates some customers to shift to synthetic substitutes such as polyester. A longer term negative for low value added sectors such as the textiles, garments and footwear industries in Indonesia concerns their loss of July-August 1994

INDONESIA: CHART 3
BALANCE OF PAYMENTS AND
RESERVES PER MONTH OF IMPORTS COVERAGE



INDONESIA: CHART 4
NON-OIL EXPORTS AND PRICES OF SELECTED COMMODITIES



pricing power as foreign purchasers (for example American footwear companies) find it increasingly viable to source these goods from other low cost Asian countries, such as China, Vietnam, India and the Philippines.

While the outlook for exports over the next year is mildly positive (not least because of the stronger external demand and cheaper currency ahead), the prospective acceleration in imports growth will likely overshadow export gains leading to further overall deterioration in the trade surplus (and in the current account deficit). Stronger import growth could be generated from three sources (chart 6). First, the economic recovery (stimulated by falling interest rates and confirmed by large rises in foreign and domestic investment approvals for the first nine months of this year) will gather greater momentum and is unlikely to be checked by higher U.S. short interest rates until well into 1995. Second, the deregulation packages announced over the last year will stimulate faster import growth. These included: a reduction in non tariff barriers on machinery and equipment, a lifting of the ban on the importation of assembled cars (replacing it with tariffs surcharges and variable sales taxes) and further reductions in the tariffs on imports of steel, copper glass and electronic products. In addition to these trade related deregulations, the government has streamlined the process of foreign direct investment licencing and relaxed several impediments to foreign investment over the last year (including restrictions on divestment for joint ventures and geographical constraints on investment). Finally, although most foreign direct investment into Indonesia is recorded through companies from Asia (ex Japan), the expansion in economic growth across Europe and Japan will give added impetus to the supply of foreign direct investment from these areas.

Perhaps one of the most noticeable aspects of the future path of interest rates in Indonesia over the next 12-18 months from a balance of payments perspective, will be the gradual shift in the main force behind them. Over the last year and a half the capital account (and in particular the private sector element) has driven the upward trend in foreign exchange reserves and downward trend in interest rates. However, in the coming year it will be a combination of (1) a worsening in the current account deficit and (2) the higher cost of running a given current account deficit which will generate rises in local interest rates (given the current exchange rate policy). Further current account deterioration over the next two years along with higher global rates of interest, would be funded by a mixture of foreign exchange reserve depletion and by a continuation of the relatively high "importation" of foreign private sector capital. However, unlike the last two years this would be accompanied by rising local interest rates, the extent of the rise being dependent on the degree to which the trade surplus actually narrows, inflation accelerates and the speed with which Bank Indonesia chooses to depreciate the Rupiah.

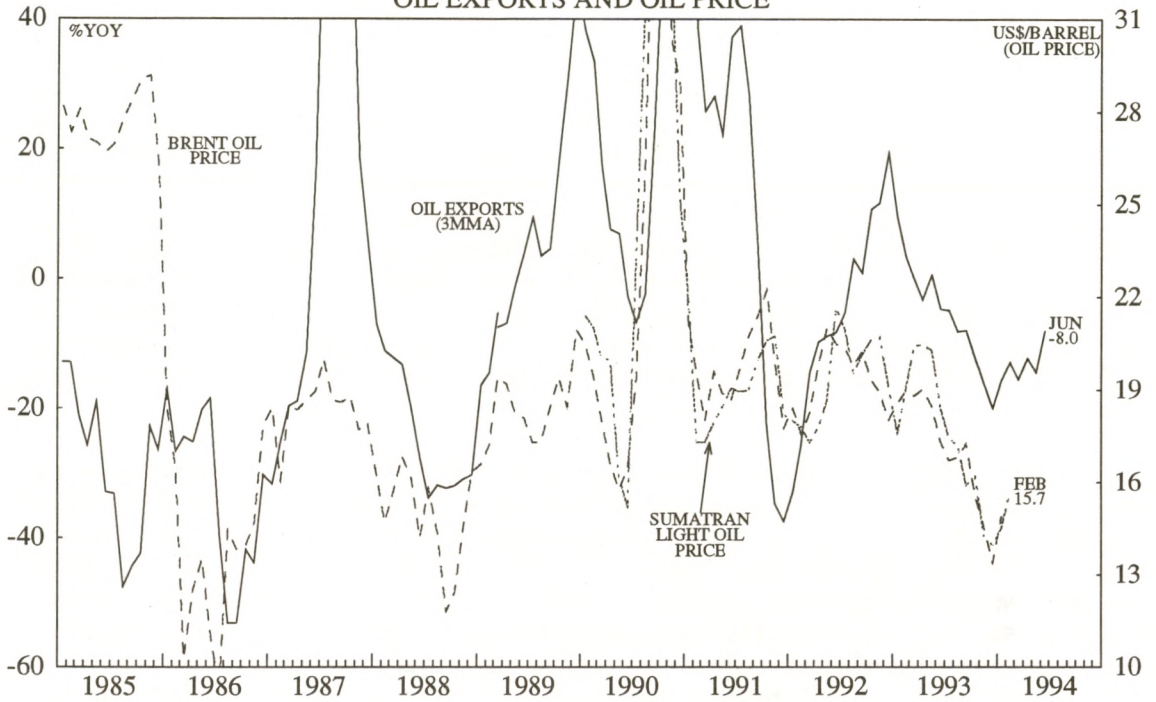
The Government Sector

The Indonesian government is constitutionally committed to running a balanced budget. Only a negligible quantity of treasury bonds or bills are ever issued, mostly taken up by the state pension scheme. Budget shortfalls are by and large adjusted by cutting back on certain expenditures and by lobbying hard each year for development aid from a consortium of international creditors. As can be seen from charts 7 and 8, this is a major source of government funding and constitutes a significant part of the capital account of the balance of payments.

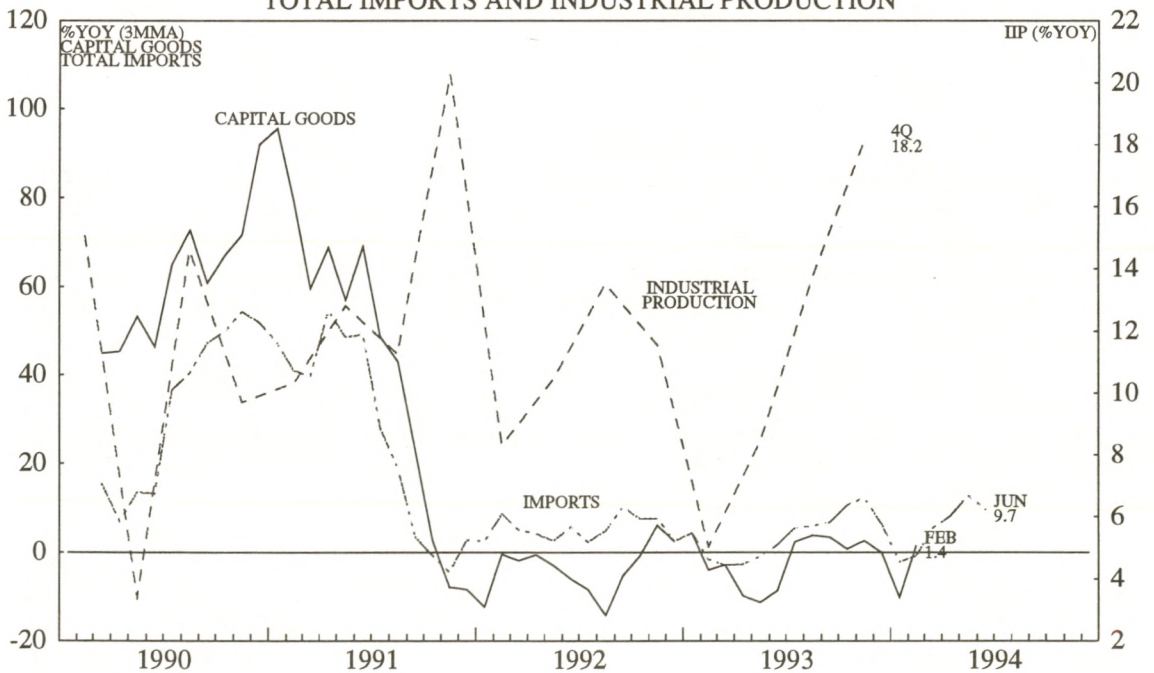
The impact of the accumulation of official foreign debt on the structure of the balance of payments is shown in chart 8. As can be seen, interest payments are a steady drain on the current account, which are only alleviated by an improvement in the trade balance,

July-August 1994

INDONESIA: CHART 5
OIL EXPORTS AND OIL PRICE



INDONESIA: CHART 6
IMPORTS OF CAPITAL GOODS,
TOTAL IMPORTS AND INDUSTRIAL PRODUCTION



as occurred from the start of 1987 to mid 1988. At that time the trade improvement brought about a rise in the stock of foreign exchange reserves (which had fallen in 1986). In addition, the amortisation of debt is a steady drain on the capital element of the balance of payments. From mid-1990 onwards there was a greater influx of foreign capital, which came to dominate the balance of payments, swamping both amortisations and the deterioration in the current account deficit (from 1990 to 1992). This resulted in a rapid accumulation in foreign exchange reserves and a much easier monetary environment (chart 9).

The ratio of total external debt to exports of goods and services has risen in recent years to around 230%, while external debt to GNP has averaged around 56%. Most of this external debt is still under the umbrella of the government, although the proportion of public or publically guaranteed debt over the last three years has declined, (from 82% to 74%). As a result, public debt as a percentage of GNP has declined from around 50% in 1989 to 42% in 1993 (while this ratio of private non guaranteed debt has risen from 7% to 13%).

In terms of flows, and its financing, the only way Indonesia can sustainably relieve itself of this debt burden is by running high trade account surpluses relative to the cost of debt service (i.e. interest payments plus debt repayments). Ratios such as debt service or interest to exports of goods and services indicate how debt constrained a country is; that is how necessary fiscal restructuring and/or a policy of monetary restraint may be. The overall debt service (amortisations plus interest payments) to exports ratio was around 33% in 1993, (22% for official debt), while the interest payments to exports ratio was 10% in 1993, (8% for official debt). Both of these have been creeping up over the last couple of years as exports have slowed, however none of these indicators (either those measuring the stock or flows of debt) are cause for concern. Although some international creditors, may need to make provisions against lending to the Indonesian public and private sectors, they would not need to demand a higher premium on rates or reduce their lines of credit on grounds of lower creditworthiness over the next couple of years. Indeed the debt service to exports ratio would improve as exports recover in the year ahead.

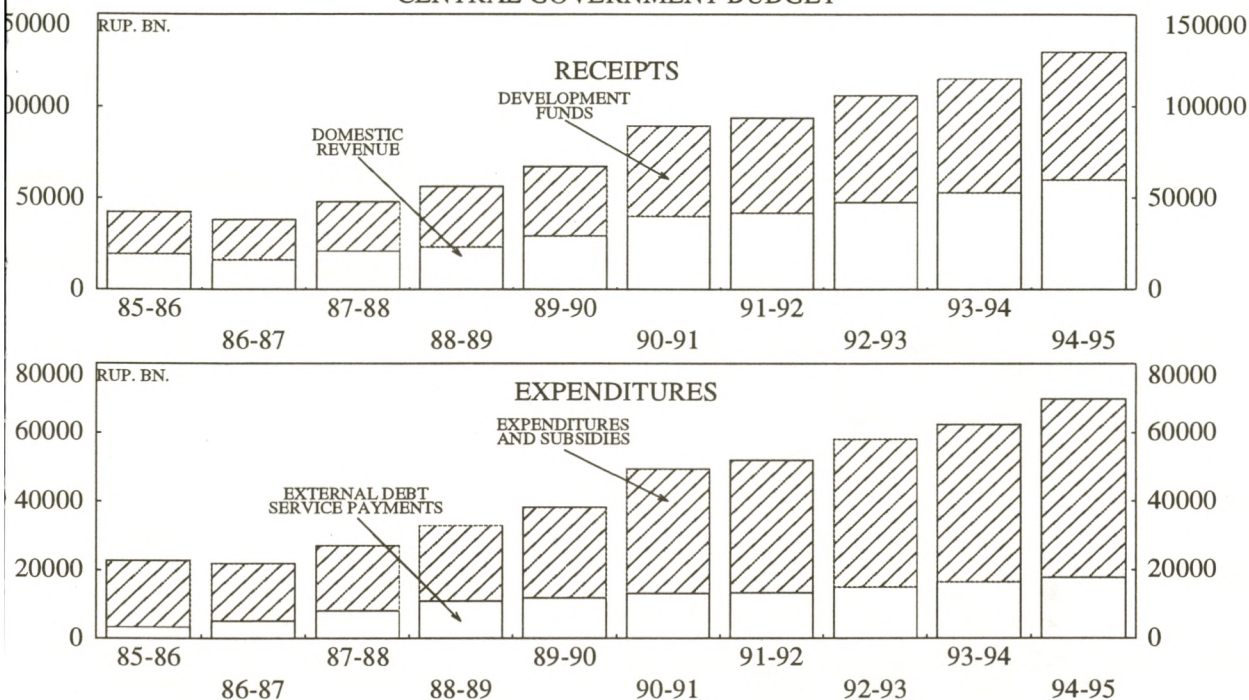
The Monetary Sector

From the point of view of the monetary impact of an overall improvement in the balance of payments, the foreign capital boom from 1991 to 1993 delivered a much larger boost to the stock of foreign exchange reserves than the current account boost in 1987 to mid 1988 (chart 9). However as explained in earlier issues of the AMM (Vol. 17 No.3, Vol. 18 No.1), the monetary environment was heavily influenced by the changes occurring in the banking system in the late 1980s and early 1990s. The aftermath of the rapid expansion of the banking system in 1988 to 1989 left many banks with poor or non-performing loans. Consequently, over 1991-92 (following the introduction of new regulations on loan loss provisioning in 1991) both state and private bank lending growth decelerated dramatically and remained weak as banks sought to repair their portfolios. In doing this they purchased large quantities of newly issued SBIs or certificates of deposit issued by Bank Indonesia and maintained higher (lending-deposit) interest rate margins.

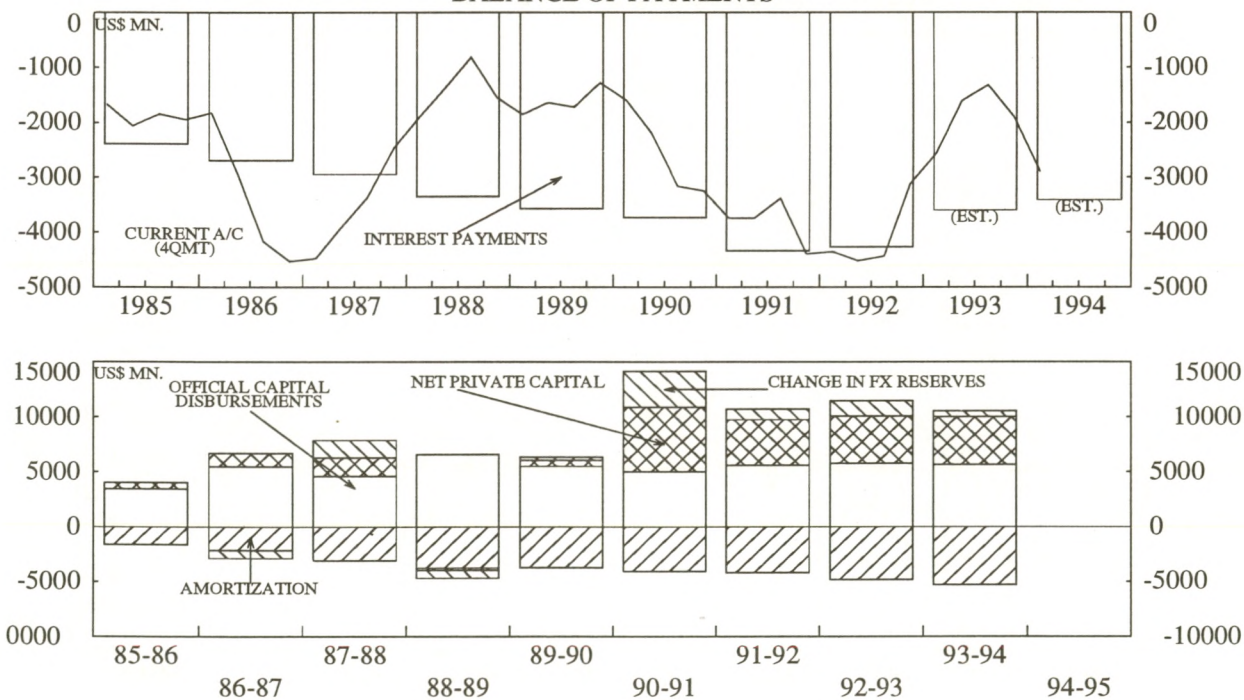
State bank lending growth (which accounts for 50-60% of total bank lending over 1990-94) has remained weak up to the present day (in October 1993, their non-performing loans averaged 21% of their loan book). By contrast, in the private banking sector, where loan portfolio quality has improved more markedly, private sector loan growth has accelerated very rapidly, albeit from a low base, over the last twelve months. From 1992 onwards, conditions in the banking sector had been extremely stimulative, for both domestic and

July-August 1994

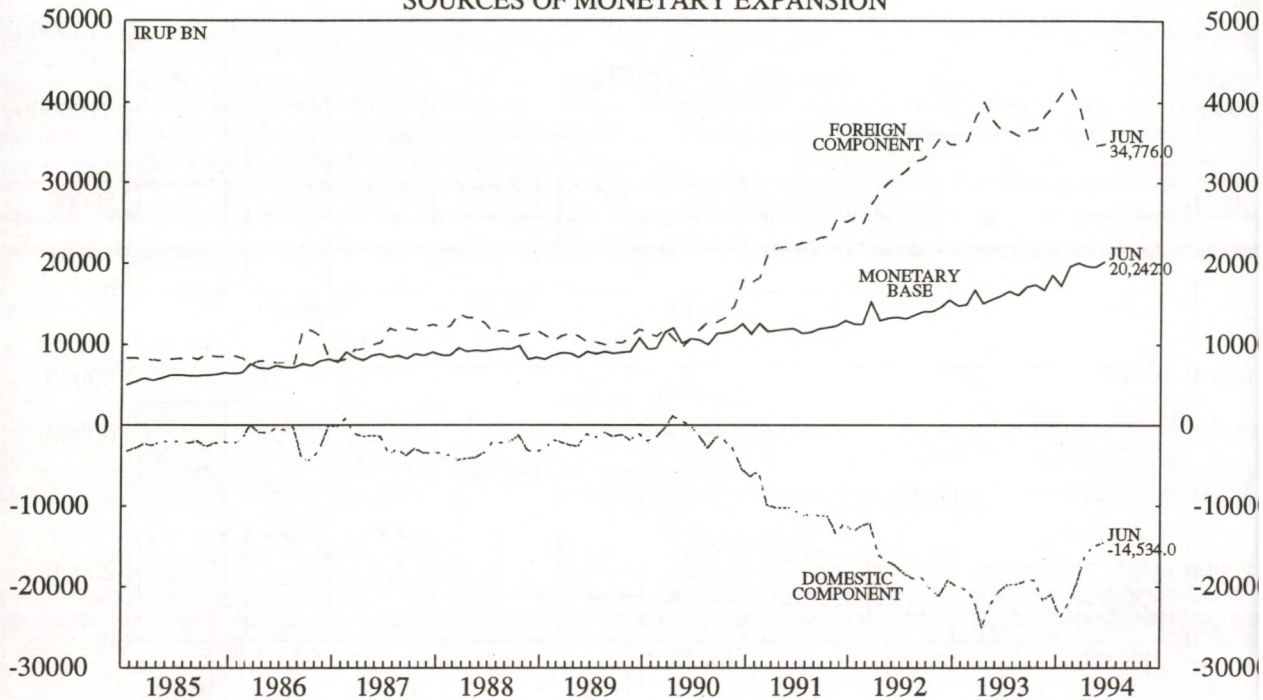
INDONESIA: CHART 7
CENTRAL GOVERNMENT BUDGET



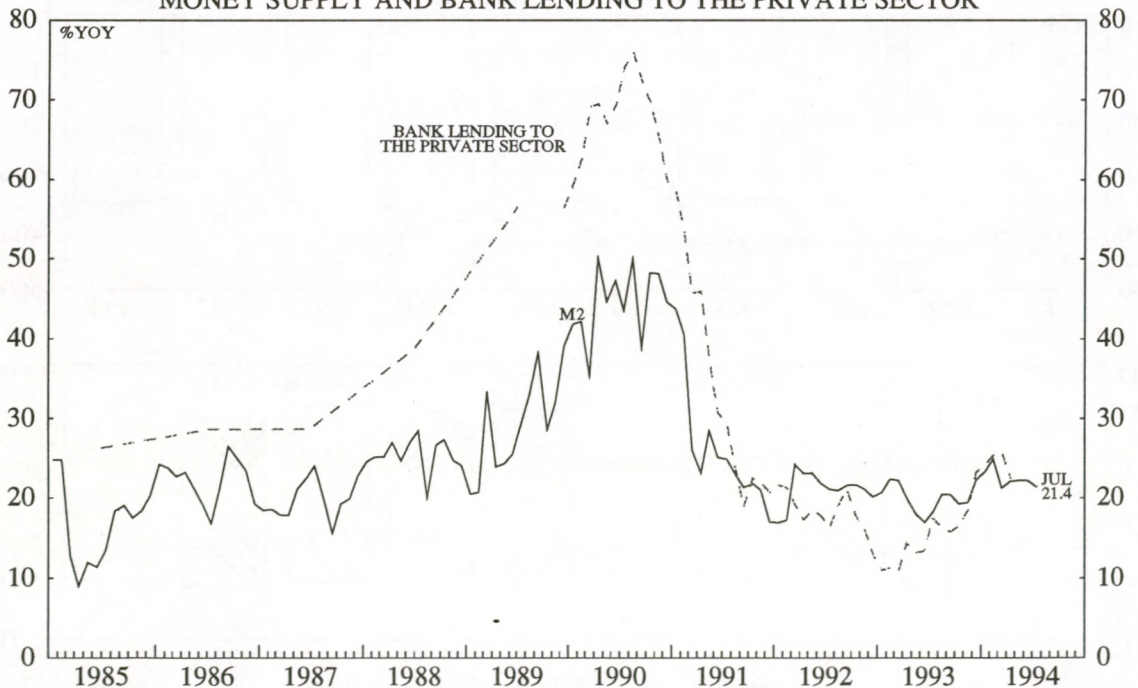
INDONESIA: CHART 8
BALANCE OF PAYMENTS



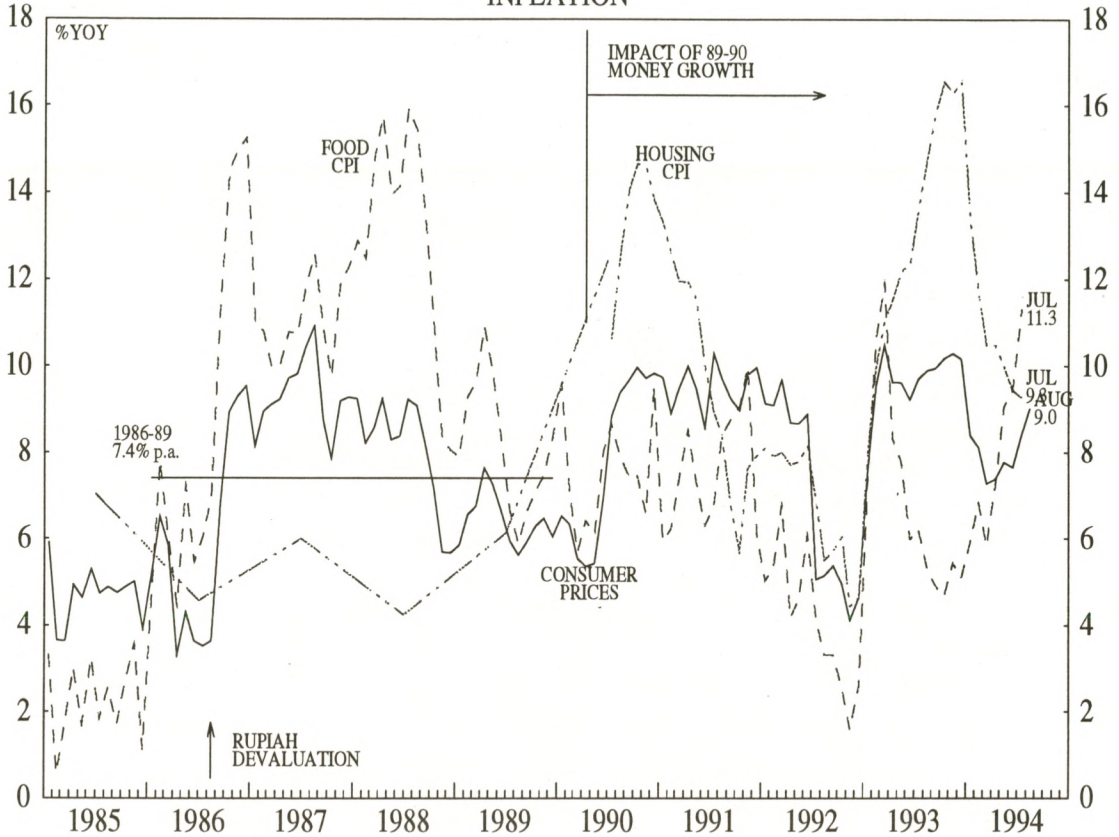
INDONESIA: CHART 9
SOURCES OF MONETARY EXPANSION



INDONESIA: CHART 10
MONEY SUPPLY AND BANK LENDING TO THE PRIVATE SECTOR



INDONESIA: CHART 11
INFLATION



external reasons. However, now that loan growth is more buoyant and the domestic economy is strengthening, it is likely that monetary conditions will tighten, in the sense that local interest rates will rise. For the immediate future this will occur as the demand for credit continues to expand, however later, after a continuation of strong credit growth and stronger broad monetary growth, Bank Indonesia will be prompted into taking additional action. Currently broad monetary growth remains stable at around 22% yoy to July (chart 10).

The rate of CPI inflation, which has been subject to large jumps due to price decontrols in the past has accelerated from around 7% to 9% since the start of the year (chart 11). Most of this acceleration has occurred over the summer when the price of food rose sharply (due to a supply shock). If the food component is stripped out of the index, inflation is seen to be decelerating and registers around 7% in July, indicating that inflationary pressures are still relatively benign. The housing element of the index is still on the decline. This is a trend which could reverse over the next twelve months as the property sector expands. Until an upward trend (excluding erratics) develops in the cost of living, effective action by Bank Indonesia to restrain credit and slow the economy down will not be undertaken.

SUMMARY AND CONCLUSIONS: As the economy gathers greater momentum over the next twelve months inflation will accelerate and the trade surplus will decline further. These factors will prompt a credit tightening in two ways. First, as mentioned earlier, higher rates of interest across the whole of the OECD coupled with a worsening current account deficit will weaken the currency. Adherence to a downward crawling Rupiah/US\$ peg will cause Bank Indonesia to support the currency at some point, placing further upward pressure on local interest rates. Second, the point at which Bank Indonesia decides to tighten (either through slower currency depreciation or by separately tightening up the local inter-bank market) will likely be dictated by the speed with which inflationary pressures feed through to the economy. At present, however, these pressures appear benign.

The greater momentum behind the domestic recovery compared with that a year ago is the major factor which will generate further asset price gains. In the year ahead, the mood surrounding the equity market will likely continue to focus on the extent to which US interest rates rise further, however the trade balance will need equally careful monitoring. Over the coming year it will likely deteriorate further, bringing forward in time the prospective rises in local rates (and an increasingly less favourable environment for equities).

MALAYSIA A MONETARY HANGOVER

On the surface Malaysia's economy appears exceptionally healthy, with real GDP growth of 8% or more every year since 1988, inflation averaging only 3.5% in the same period, and the balance of payments in surplus thanks to strong capital inflows. However, underneath this calm surface there are mounting tensions as the saga of Malaysia's attempts to cope with these strong capital inflows continues. This article will first provide a brief historical background on the economic policies which attracted these capital inflows and led to the present monetary overhang; and then try to quantify the size of the monetary overhang and the capacity of the economy to translate it into continued real economic growth, or alternatively the likely acceleration in inflation or deterioration in the balance of payments.

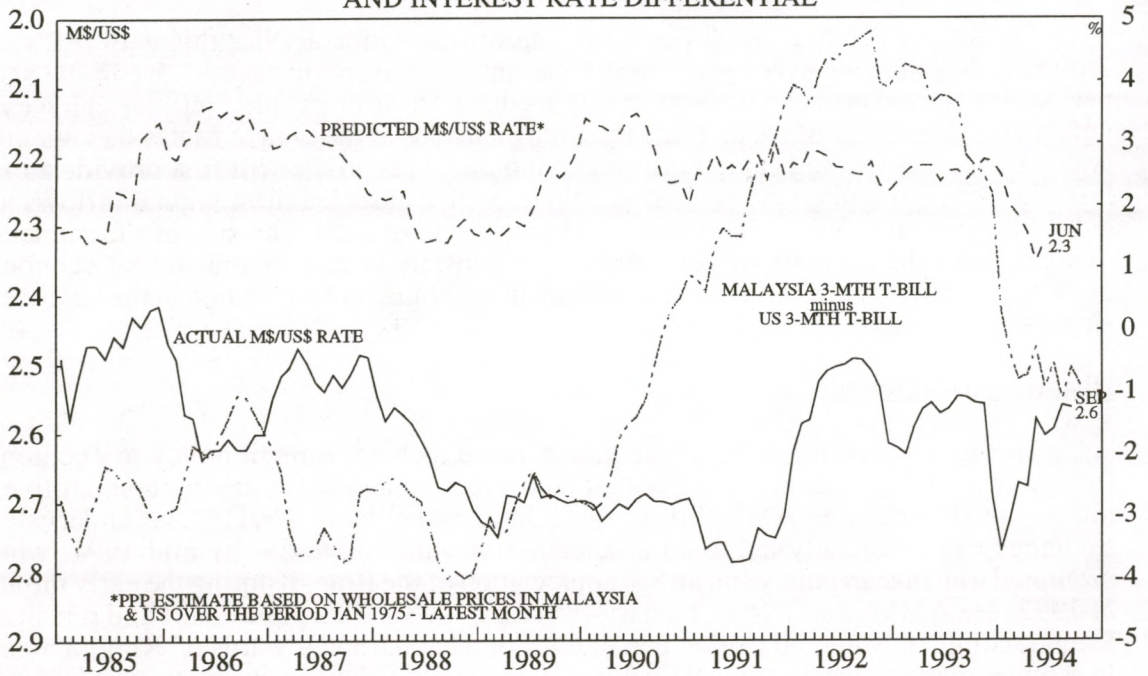
Historical background

During most of the 1980s, Malaysia pursued a cheap Ringgit policy to encourage foreign investment by keeping the cost of land, labour and other resources competitive in international terms (see AMM Vol.15 No.1 January-February 1991). The undervalued exchange rate eventually led to an acceleration in inflation to 5% by mid-1991, which prompted a change in policy and an 8% appreciation of the Ringgit during the early months of 1992 (see AMM Vol.17 No.1 January-February 1993). This policy shift and rise in the Ringgit completely altered market perceptions of the risks and rewards of Ringgit assets. In essence, market participants had finally spotted a major policy inconsistency in Malaysia's attempts to pursue three mutually incompatible policy objectives: an undervalued exchange rate (to maintain export competitiveness), interest rates in excess of international levels (to contain domestic money supply growth), and an open capital account (to attract continued inflows of foreign investment) (Chart 1). This policy inconsistency made the Malaysian Ringgit a one-way bet for speculators who stood to gain from both a positive interest rate differential and an expected appreciation of the Ringgit -- especially at end-1992 and end-1993 when the exchange rate was depressed further, allegedly to increase the Ringgit value of the official foreign exchange reserves.

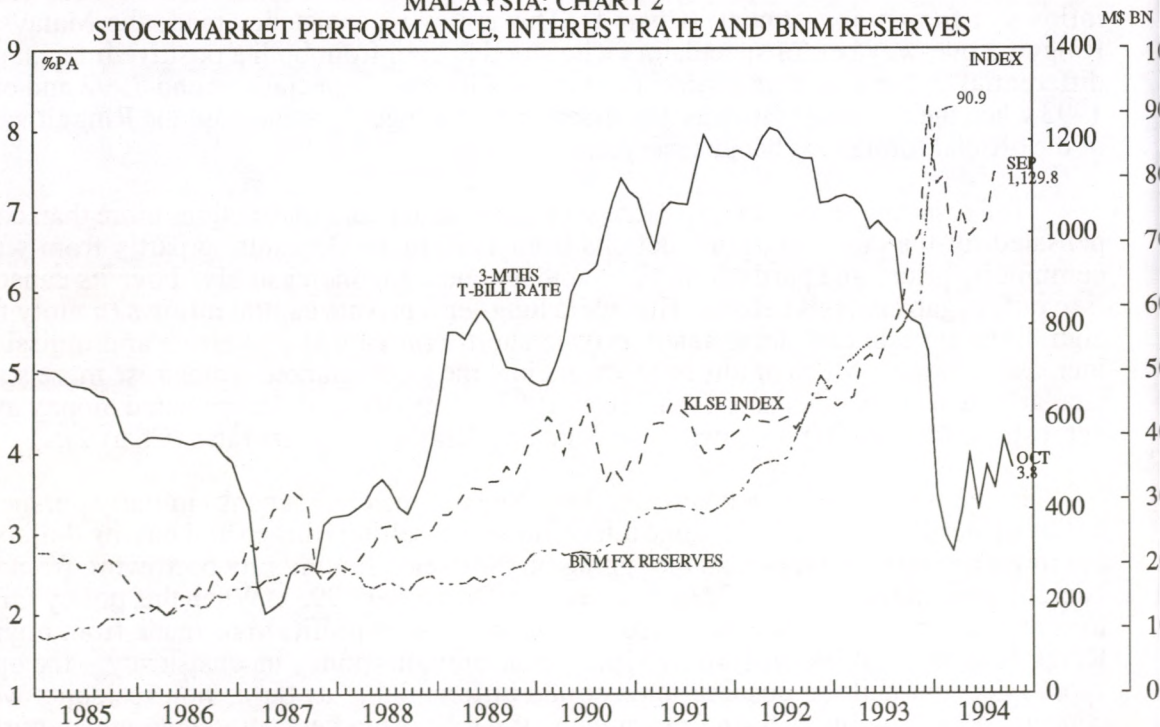
The resulting surpluses on private sector capital account transactions more than compensated for the current account deficits from 1990 to 1993, resulting partly from weak commodity prices and partly from the economy operating increasingly above its capacity (see output gap analysis below). But while long-term private capital inflows (mainly foreign direct investment) decelerated, private short-term capital and errors and omissions increased sharply. Much of this inflow went into the stock-market, which rose more spectacularly than many other stock-markets in 1993, or into Ringgit denominated money market instruments, putting downward pressure on Malaysian interest rates (Chart 2).

Faced with inflows on this scale, Bank Negara (the central bank) initially pursued a policy of sterilised foreign exchange intervention, i.e. selling Ringgit and buying dollars in the foreign exchange market and mopping up the excess liquidity by borrowing from the banking system (AMM Vol.17 No.6 November-December 1993). When this policy failed to change the market's view that there were near risk-free profits to be made from buying Ringgit assets, Bank Negara removed part of the previous policy inconsistency -- the open capital account and the positive interest rate differential -- as far as non-residents were concerned, by prohibiting them from buying local money market instruments, and requiring their deposits to be placed in Bank Negara vostro balances at a penal negative 3% rate of

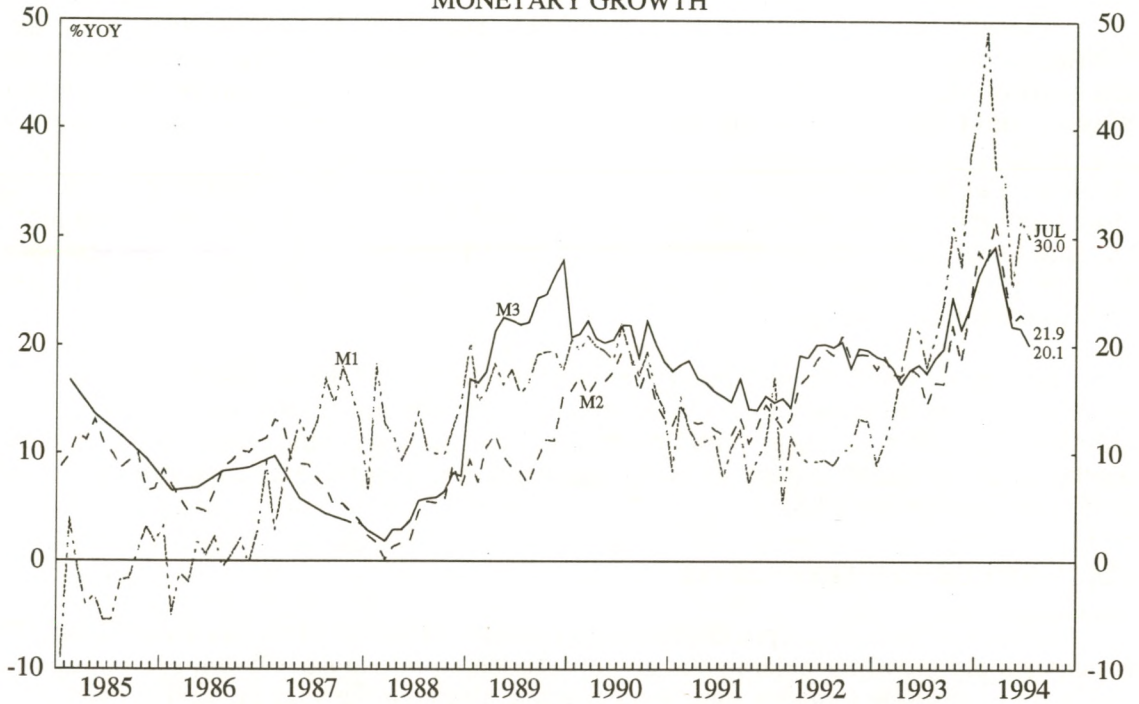
MALAYSIA: CHART 1
EXCHANGE RATE (ACTUAL & PPP ESTIMATE)
AND INTEREST RATE DIFFERENTIAL



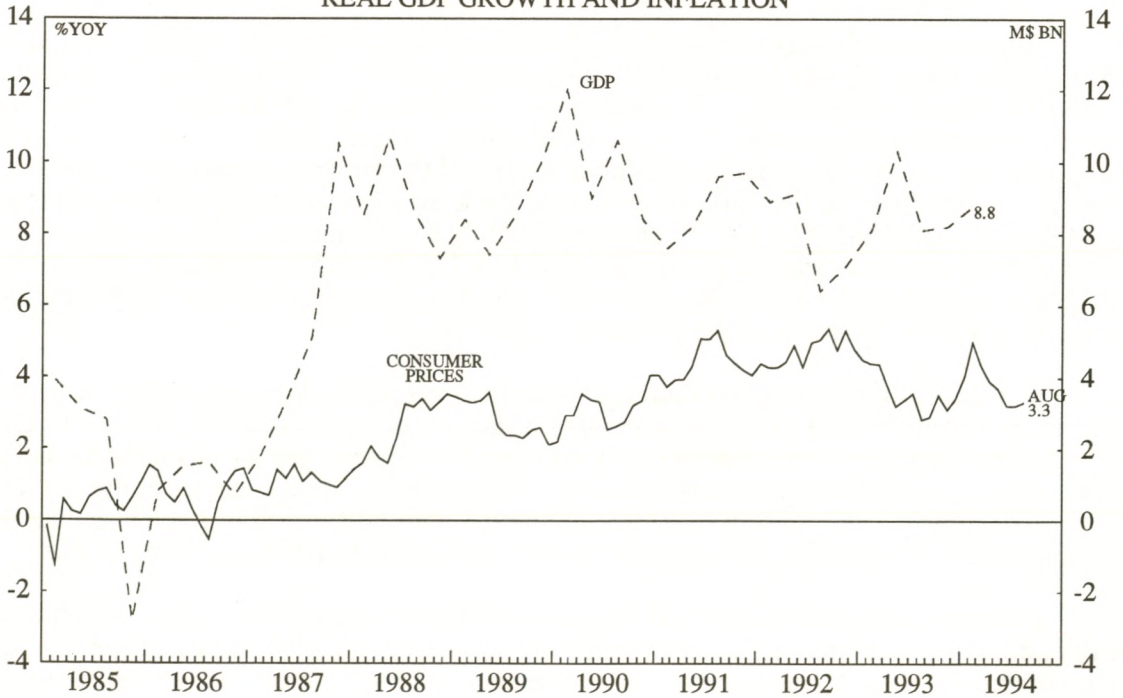
MALAYSIA: CHART 2
STOCKMARKET PERFORMANCE, INTEREST RATE AND BNM RESERVES



MALAYSIA: CHART 3
MONETARY GROWTH



MALAYSIA: CHART 4
REAL GDP GROWTH AND INFLATION



interest (See AMM Vol.18 No.1 January-February 1994).

These measures now appear to have been successful in scaring away some less confident foreign speculators, whose cost of carrying their long Ringgit positions rose as the interest rate differential turned from mildly positive to strongly negative. But resident players could still borrow dollars and place Ringgit at a positive interest rate, and though non-resident vostro balances declined, the total amount of sterilisation needed remained stubbornly high. Bank Negara therefore started to cut the cost of sterilisation by switching from relatively expensive instruments, i.e. interbank borrowings, to cheaper instruments, i.e. statutory reserve requirements (increased three times so far to 11.5% at present) and Bank Negara Bills, and by accommodating a decline in the interbank rate easing the cost of their interbank borrowings.

In August Bank Negara finally realised the futility of the stand-off and lifted the remaining restrictions on non-resident purchases of bonds and money market instruments, although they followed this up with "tough" warnings that they could eliminate the offshore market at the stroke of a pen, and with intervention to cap the exchange rate at around 2.55-2.66 Ringgit per US\$.

Quantifying the monetary overhang

However, the whole episode has had a dramatic effect on Malaysia's money supply. Money supply growth accelerated at an unprecedented rate in early 1994, and contracted modestly in absolute terms in some later months, although the year-on-year growth rates have remained stubbornly above 20% for all the monetary aggregates (Chart 3). In its simplest form the quantity theory of money suggests that (assuming a stable money demand function) this will (with a 1-2 year lag) lead to a 20% rise in nominal GDP -- compared with nominal GDP growth of around 13% at present (Chart 4).

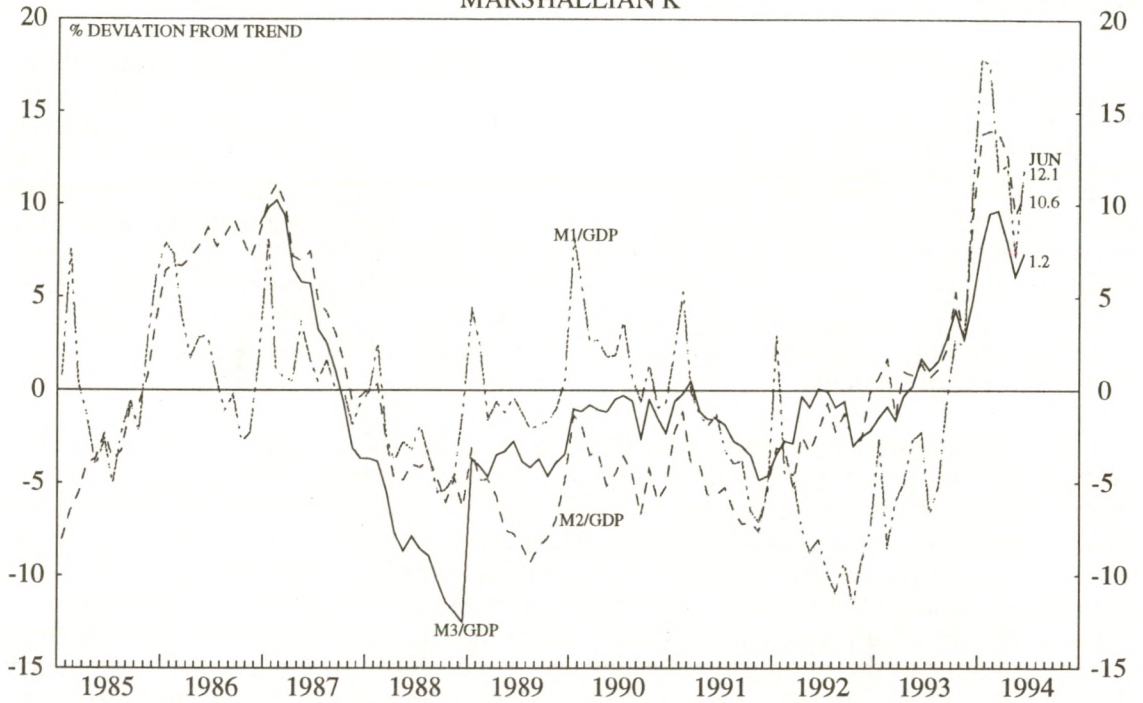
Another possible way of quantifying the excess money supply growth is to look at the Marshallian k (i.e. Money Supply divided by nominal GDP), and in particular the deviations of k from its long-run trend, which suggests that the episode of capital inflows has created a substantial monetary overhang of which Bank Negara has only eliminated a small proportion (Chart 5). The Marshallian k values for all the monetary aggregates have been well above trend for the first half of 1994, with the k for M1 averaging 8.1% above trend, k (M2) 12.4% and k (M3) 13.1%. Even on the slightly longer horizon of 12 months to June 1994 k (M1), was on average 5.2% above trend, k (M2) 7.5% and k (M3) 6.2%. This in turn suggests that unless the monetary overhang is dealt with swiftly, nominal aggregate demand may well accelerate by upto a similar magnitude.

How much of this incipient increase in nominal aggregate demand can be met by real aggregate supply? That crucially depends on the spare capacity in the economy. One overly simplified way of measuring this is to calculate an output gap based on the deviation of GDP away from its long-run trend (Chart 6). On this basis, Malaysia's economy will this year (assuming 7% real growth) operate at around 3.5% above trend -- much less than the prolonged 4%-6% positive output gap experienced in the late 1970s and early 1980s.

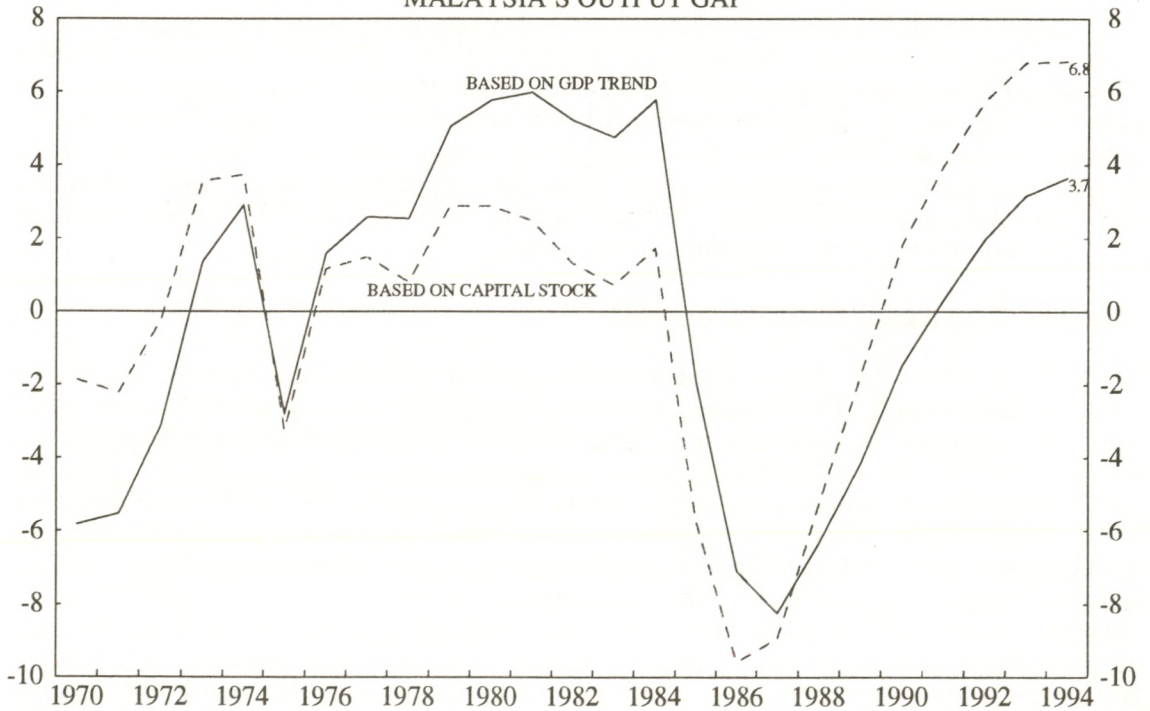
However, this crude output gap based on GDP trend ignores the factor which critically affect the productive capacity in the economy -- investment. In the early years of this long cyclical upswing aggregate demand was matched by increases in aggregate supply resulting from productivity gains and strong investment (both foreign and domestic) in the early 1980s. Underinvestment in the second half of the 1980s, however, meant that aggre-

July-August 1994

MALAYSIA: CHART 5
MARSHALLIAN K



MALAYSIA: CHART 6
MALAYSIA'S OUTPUT GAP



gate supply may not have kept pace with aggregate demand, and that even the somewhat higher levels of investment in the early 1990s may not have rectified the situation.

An alternative model of the output gap can be obtained by estimating potential output as a function of the economy's capital stock, based on the simplifying assumption of a stable one-factor production function with a constant Incremental Capital-Output Ratio (ICOR). As no data exists for the capital stock as such, a proxy based on cumulative Gross Fixed Capital Formation less depreciation has been used. Several values for initial capital stock and depreciation rates were tried. Combinations of depreciation rates between 10% and 15% and initial capital stocks of 4-8 times GFCF tended to yield regression results significantly better than regressing GDP on a time trend, while a depreciation rate of 12% yielded the most significant results. On this basis, Malaysia's GDP was growing at only 1%-2% above trend capacity in the late 1970s and early 1980s, but is now operating at almost 7% above capacity.

The assumption of a constant ICOR can be criticised, especially in the case of a dynamic economy like Malaysia, for ignoring changes in the rate of factor productivity improvements. However, given the path of capital formation one would have to make some quite strong alternative assumptions (slow factor productivity improvements in the late 1970s and early 1980s, and much more rapid factor productivity improvements in the late 1980s and early 1990s) in order to argue that Malaysia's economy is not operating at or significantly above full capacity. On these assumptions it can be argued that there has been a structural shift in the trend growth rate from around 5-6% in the late 1970s and early 1980s to 7-8% in the late 1980s and early 1990s. However, even on the assumption of such a structural shift in the trend growth rate due to strong productivity improvements current output would probably still be above full capacity, although the output gap would be smaller than suggested by our model.

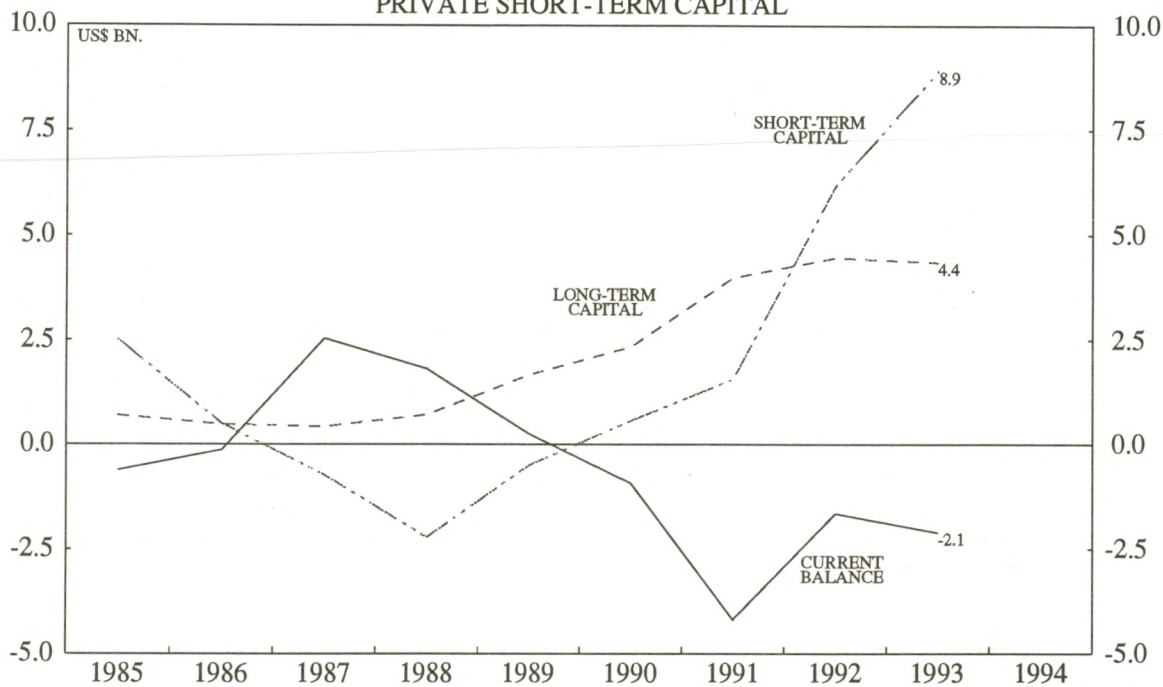
But although Malaysia's economy is probably operating above full capacity, the adjustment back to (or below) full capacity may well be delayed and quite possibly gradual. Malaysia has managed to grow above trend and at full capacity for prolonged periods in the past and may well be able to sustain this boom well into 1995. Even beyond that the adjustment may well be gradual. Indeed, auto-regression of the error terms (actual output less estimated potential output) suggests that actual output adjusts to potential output at a rate of around a quarter of the error term per annum. However, real GDP growth in excess of 8% per annum is unlikely to continue indefinitely.

How will the monetary overhang unwind?

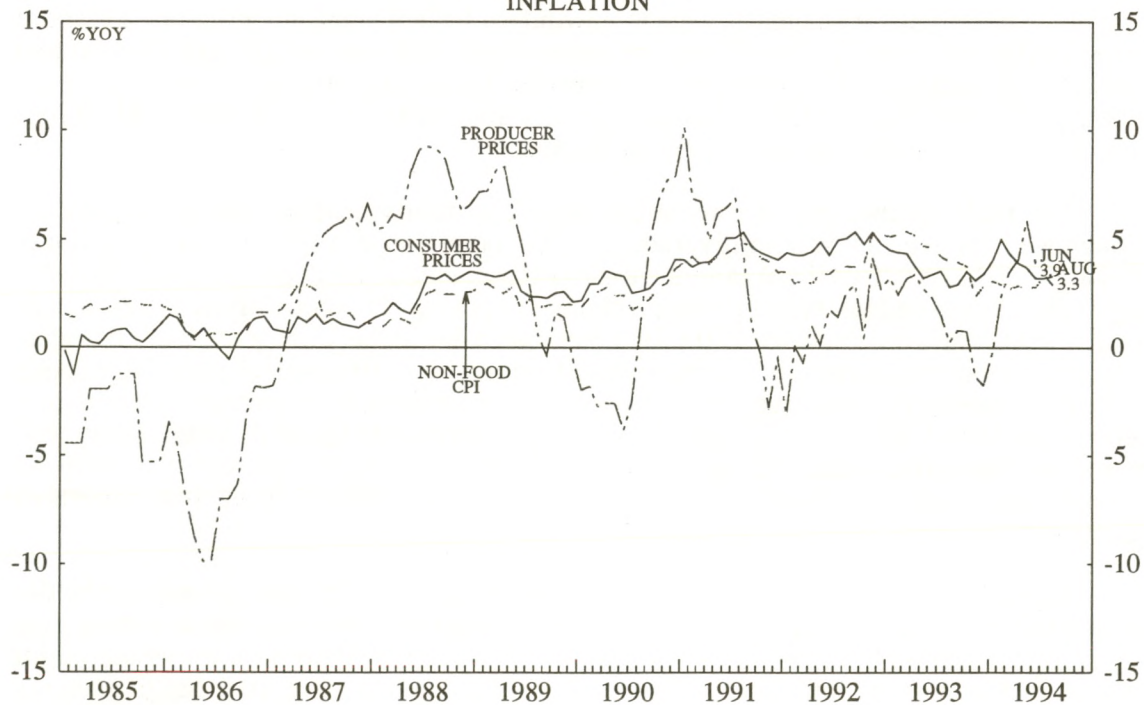
The question therefore remains how the remaining excess real money balances are going to be unwound. There appears to be three possible routes: an acceleration in inflation, a deterioration in the trade (or services) balance, or capital outflows (Chart 7).

Inflation has remained surprisingly subdued judging by the official CPI numbers (Chart 8). In the first half of the year there was a modest extension of price controls on some food items in response to accelerating food price inflation, accompanied by ministerial exhortations to shop-keepers to refrain from increasing prices. It is possible that the CPI underestimates the true cost of living as property prices are reported to have been rising fast, and as many shops may have kept list prices constant but scaled back on available discounts. But at this juncture the authorities cannot claim with much credibility that inflation poses any serious threat to the economy, and until the measured rate of inflation reaches a level where it instills a sense of crisis it is unlikely to provoke a strong policy response. How-

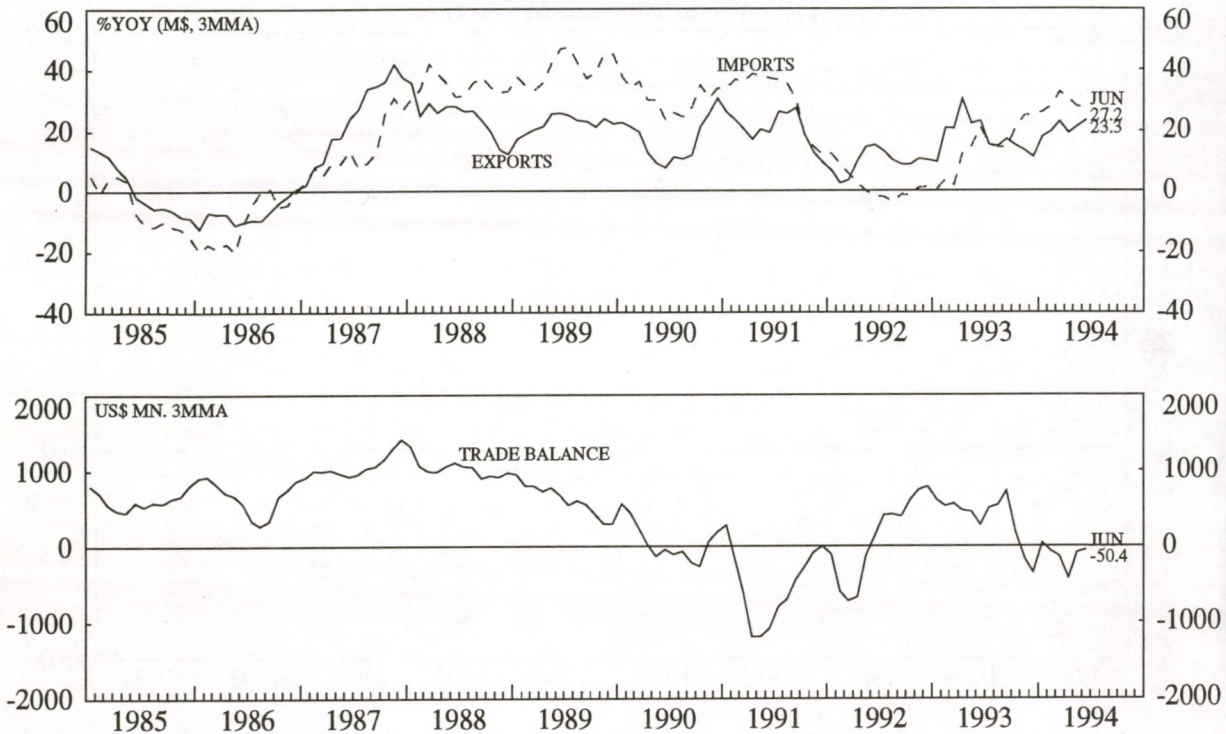
MALAYSIA: CHART 7
BALANCE OF PAYMENTS, PRIVATE LONG-TERM CAPITAL AND
PRIVATE SHORT-TERM CAPITAL



MALAYSIA: CHART 8
INFLATION



MALAYSIA: CHART 9
TRADE PERFORMANCE

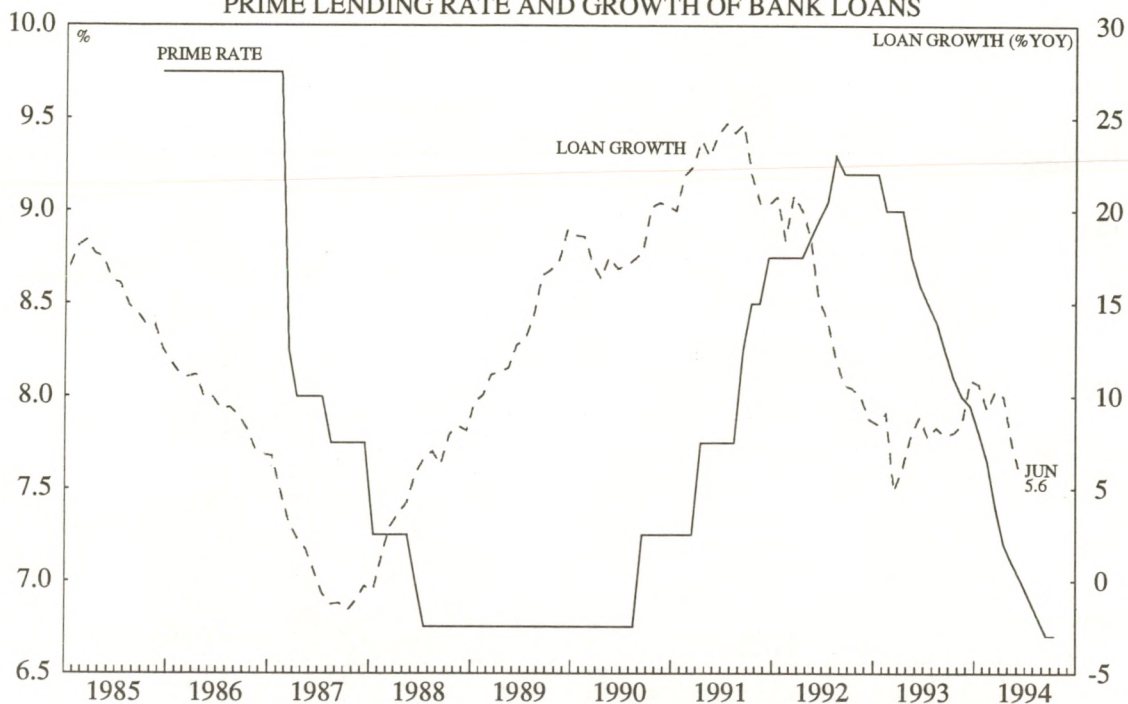


ever, if the excess money balances were to unwind exclusively through inflation, we would expect inflation to reach politically unacceptable levels (year-on-year rates of 5%+ for two consecutive months and/or short-term annualised inflation rates of 10%+) within the next 6 months. Meanwhile, anecdotal evidence suggests that asset prices, and in particular property prices, have accelerated substantially this year.

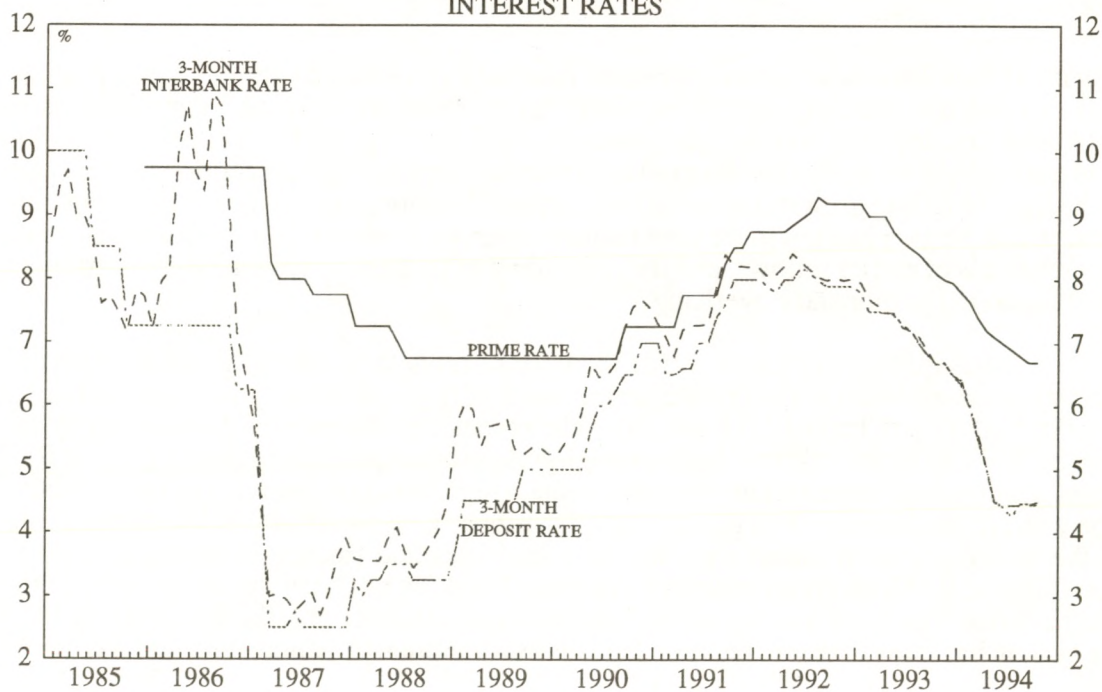
The trade balance has also remained in an apparently healthy state so far, and although we have seen a few monthly trade deficits, it remains in surplus on a twelve month moving total basis (Chart 9). Again, the trade performance so far does not appear to instill any sense of crisis which might prompt a change in policy. Theoretically, if the monetary overhang is to unwind exclusively through the trade balance, i.e. if the excess of aggregate demand over aggregate supply is to be met with imports and diversion of potential exports to meet domestic demand, we would expect a sharp reversal of the trade surplus to a substantial deficit. However, the onset of such a deterioration in the trade balance may well be delayed by a rise in the unit values of commodity exports, and possibly by curbs on imports (e.g. postponement of official sector imports and exhortations against imports of consumer goods).

Capital inflows may have stabilised as Bank Negara's earlier anti-speculation tactics succeeded in intimidating some less confident non-resident players to liquidate their long Ringgit positions. However, serious capital outflows are unlikely as long as the major players in the market (both local and foreign) continue to perceive the Ringgit as being fundamentally undervalued. The current gap between the actual exchange rate (2.56 MR/US\$) and market perceptions of fair value (2.45-2.40) is likely to initially narrow as Bank

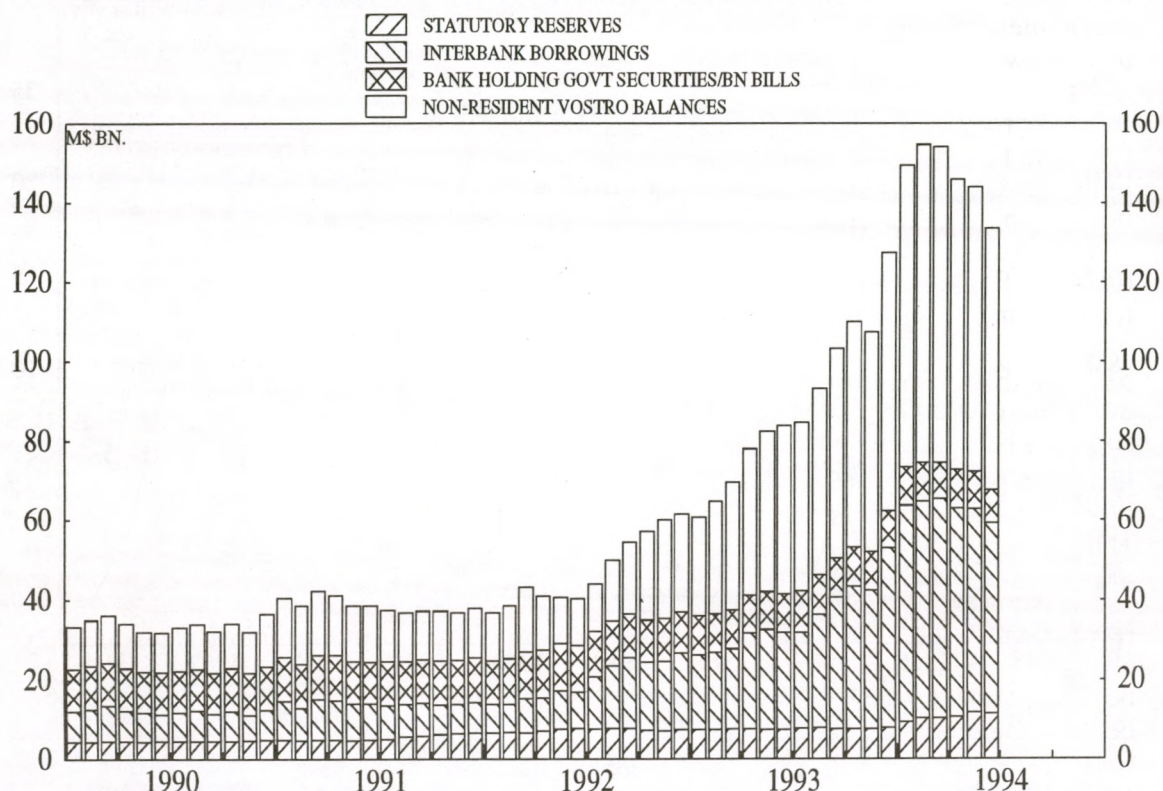
MALAYSIA: CHART 10
PRIME LENDING RATE AND GROWTH OF BANK LOANS



MALAYSIA: CHART 11
INTEREST RATES



MALAYSIA: CHART 12
BANK NEGARA STERILISATION MEASURES



Negara allows the actual rate to appreciate modestly (probably to around 2.50), probably in the run-up the election, with the resulting deterioration in the trade balance not visible until after the election. But the gap between actual and expected value might only close (and quite likely overshoot) when market participants revise their perceptions of fair value in the light of falling growth, rising inflation and/or deteriorating balance of payment numbers. Bank Negara has got more than enough reserves to meet those outflows that represent reversals of earlier inflows, and the unwinding of those reserves will also contribute to a reduction in the monetary overhang.

What is quite remarkable is that the current monetary overhang has not (yet) fed through into bank loan to the private sector, especially given the very low current interest rates in Malaysia (Charts 10, 11 and 12). The revealed preference of the banking system appears to be to make risk-free loans at negligible profits (perhaps even at a loss) to Bank Negara rather than make slightly riskier but much higher margin loans to the private sector. There are several more or less plausible explanations. One possibility is disintermediation of the banking system through private debt securities and finance companies. Another possibility is that loan commitments have risen, but have not been drawn down as corporate cash flow has been more positive than expected. Another possibility is that the banking system has viewed the increase in deposits as a temporary phenomenon and have there-

fore refused to intermediate it into loans. If it is indeed reluctance by the banking system to transform the monetary overhang into loan growth, this may slow the unwinding of the overhang somewhat, but is unlikely to prevent it completely, as many of the households and companies who may wish to spend the monetary overhang are long in cash and don't need to borrow.

A pro-active tightening of monetary policy (through a sharp appreciation of the Ringgit followed by a sharp rise in interest rates) could still reduce the monetary overhang and its likely adverse consequences for inflation and the balance of payments, but appears quite unlikely before the general election. Even after the election, Bank Negara is unlikely to adopt too contractionary a monetary stance until it has sufficiently adverse inflation and/or balance of payments figures to justify such a policy change politically. By then it may be too late, and 1995 may well see a repeat of the slowdown of 1985.

SUMMARY AND FORECASTS: Malaysia's economy faces a problem of a substantial monetary overhang which is likely to push up aggregate demand at a time when aggregate supply is becoming increasingly inelastic. Eventually this is likely to lead to a deceleration in economic growth, a deterioration in the balance of payments and/or an acceleration in inflation. The timing of these problems is uncertain, but quite likely to be in the first half of 1995.

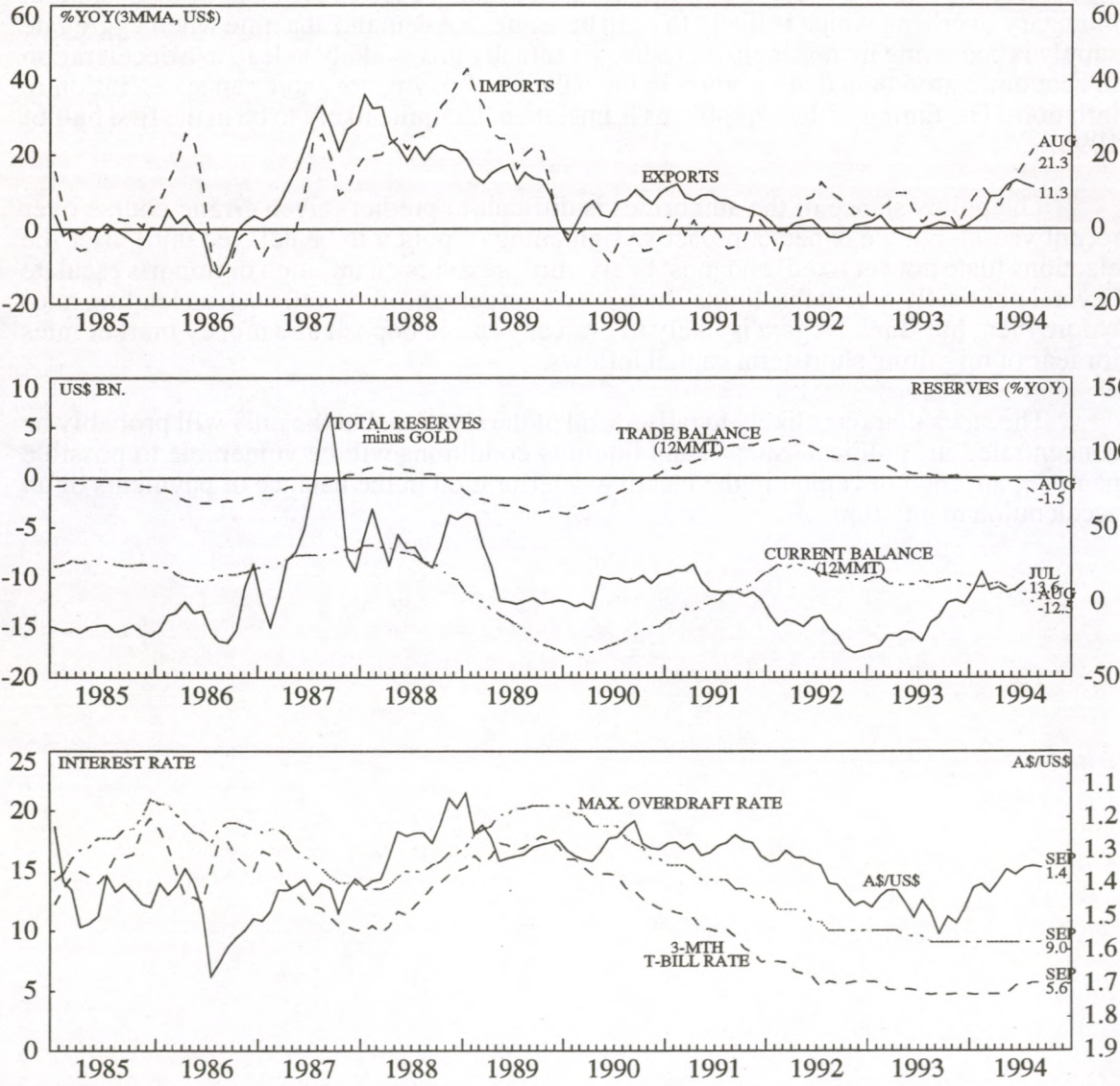
The policy stance of the authorities is difficult to predict (given erratic course over recent years), but we expect a proactive tightening of policy to be delayed until after the elections (date not yet fixed) and most likely until pressures on inflation or imports escalate beyond politically acceptable limits. Increased loan demand may well push up lending rates before then, but Bank Negara is likely to limit any rise in deposit and money market rates for fear of reigniting short-term capital inflows.

The stock market is likely to rally ahead of the election, but the rally will probably be concentrated in "political" stocks, and liquidity conditions will be vulnerable to possible panic repatriation of capital in the fact of a deterioration in the balance of payments or an acceleration in inflation.

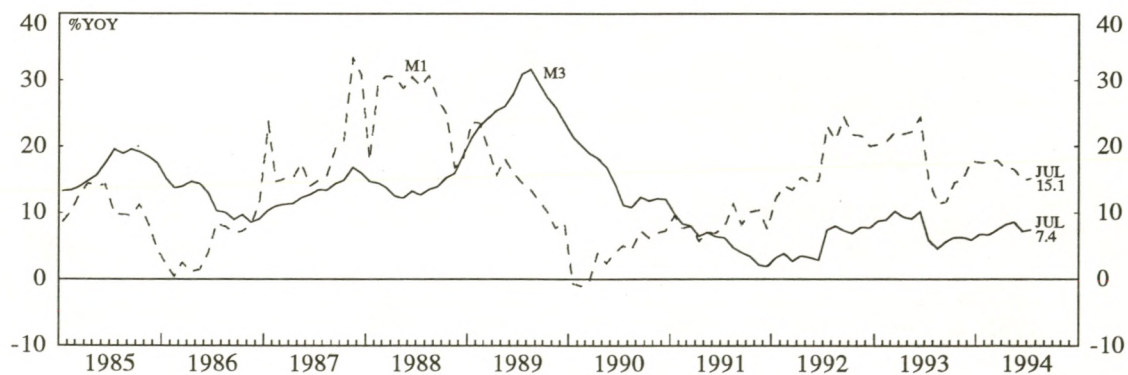
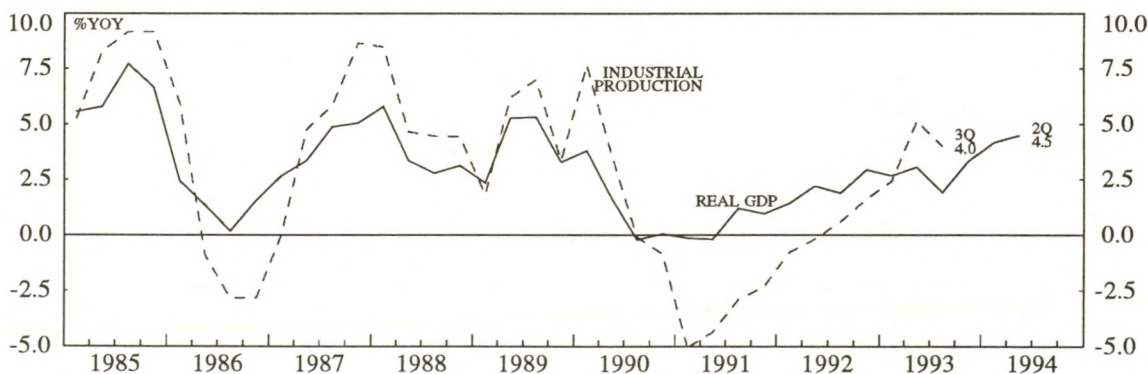
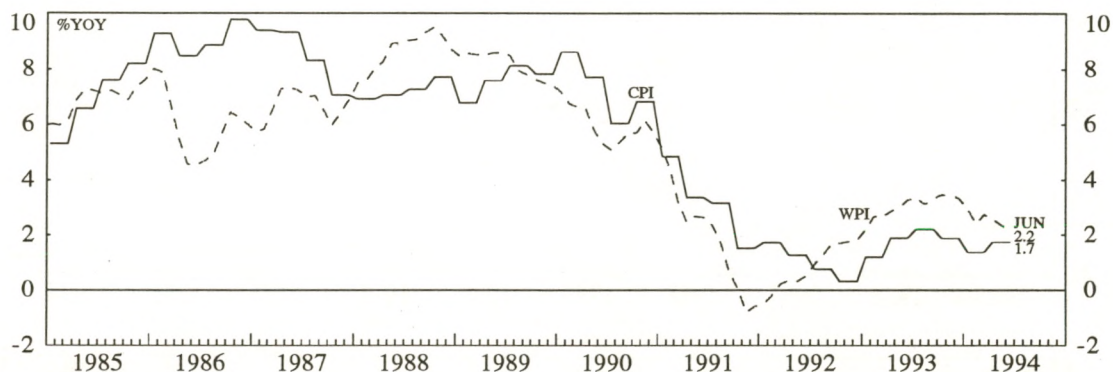
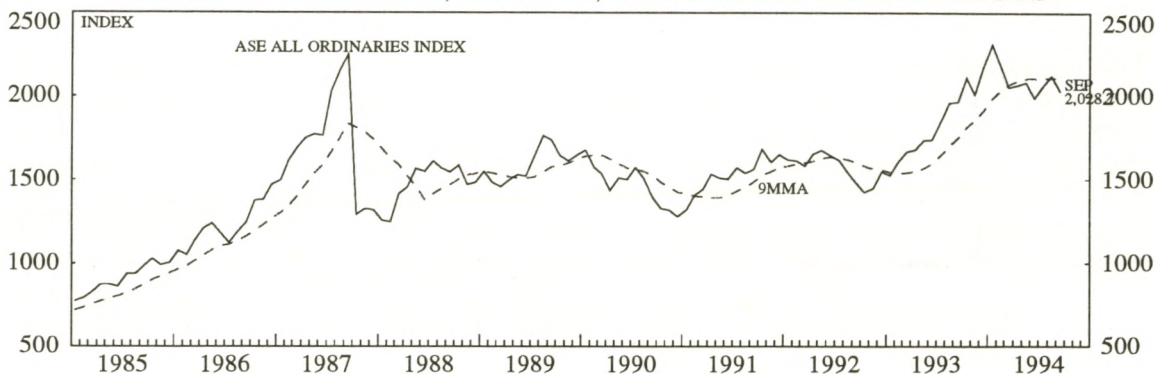
AUSTRALIA: CHANGE IN COMPOSITION OF GROWTH AHEAD

The Australian economy is growing strongly after a slow start to the current expansion. A shift from consumer spending towards higher capital expenditure is likely over the forthcoming year. Bond yields, now around 10.3%, are too high relative to inflation prospects or credit demand. Nevertheless a flattening of the yield curve in terms of future long bond gains would require further tightening in monetary policy first. Delays in this could result in a further back up in long yields, given the low anti-inflationary credibility and fiscal "impropriety" of Australian authorities in the eyes of international investors. A continuation in the OECD recovery coupled with healthy Asian economic growth bodes for stronger commodity prices and a firm A\$ in the year ahead, despite the recent trade account deterioration.

AUSTRALIA: MONEY MARKET AND BALANCE OF PAYMENTS



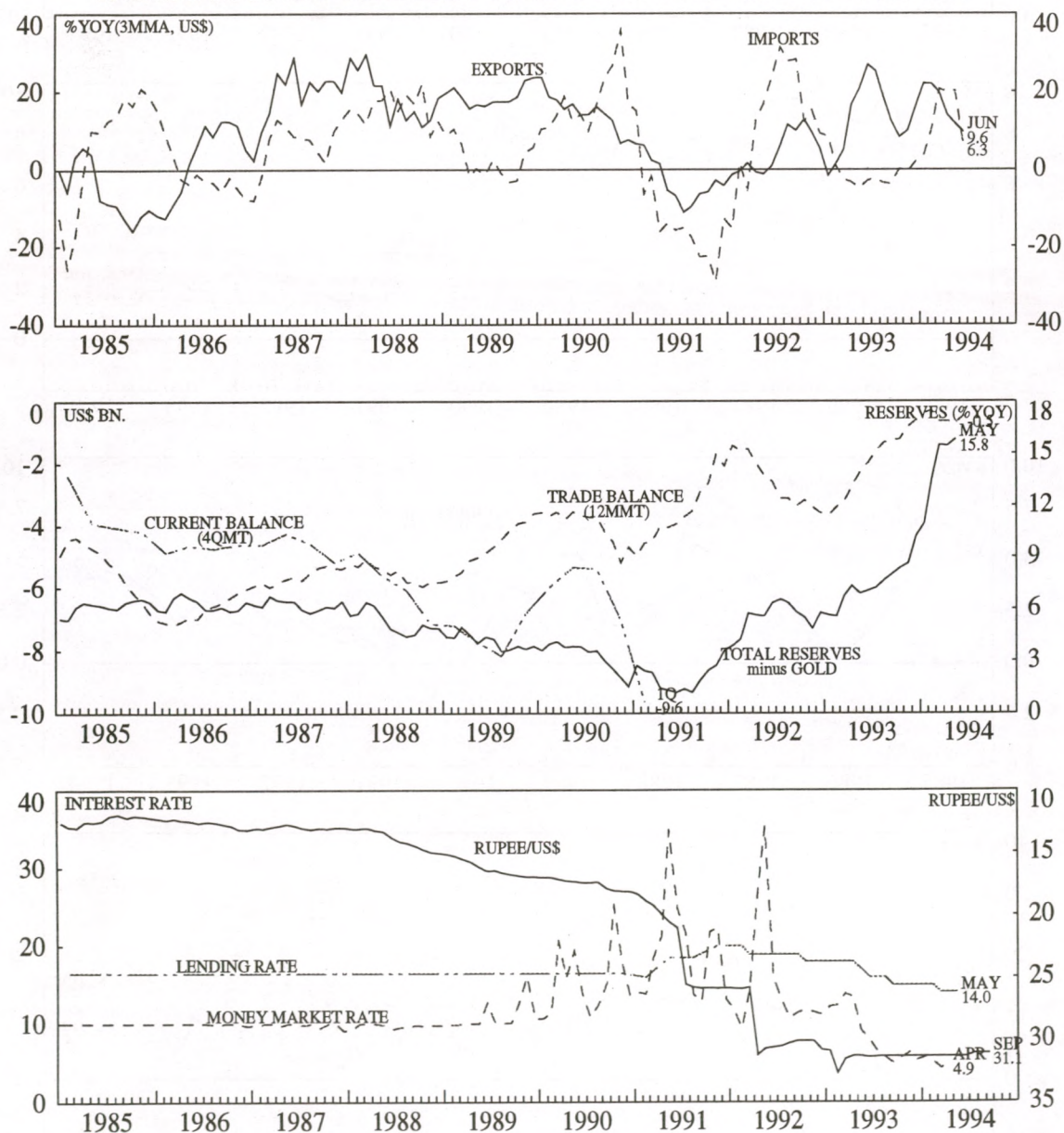
AUSTRALIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



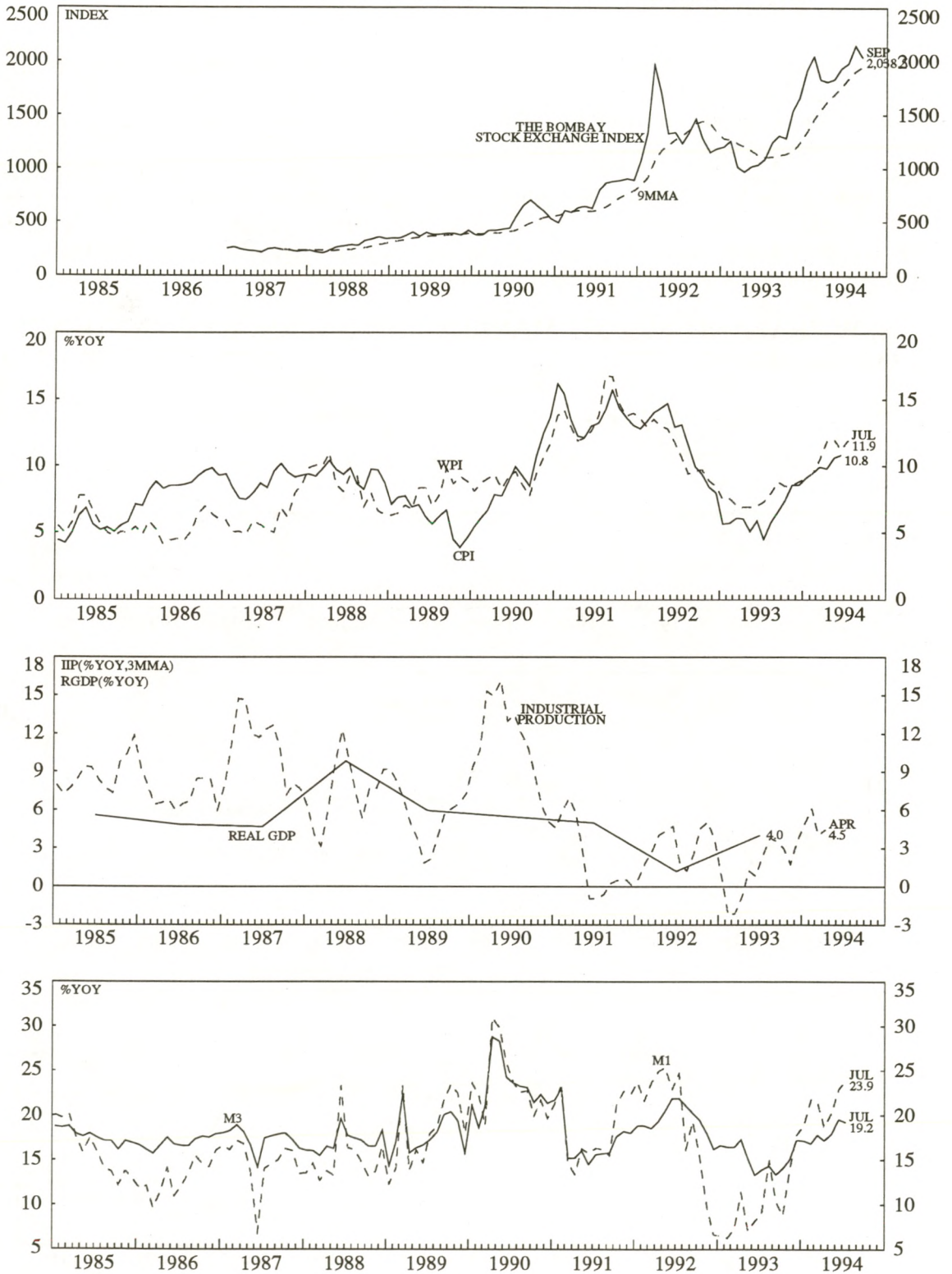
INDIA: EXPANSION CONTINUES AIDED BY FOREIGN CAPITAL

Foreign exchange reserves have continued to rise (fuelling more rapid monetary growth) over the last year as (1) permission has been granted to a greater number of foreign institutional investors to enter the capital market and (2) as more corporations are able to raise money offshore. The economy is enjoying a sustainable recovery with higher inflation and a deteriorating current account deficit on the horizon. In the meantime the upward pressure on the currency is encouraging the authorities to speed up their removal of some import barriers and place limits on India's overall foreign debt growth.

INDIA: MONEY MARKET AND BALANCE OF PAYMENTS



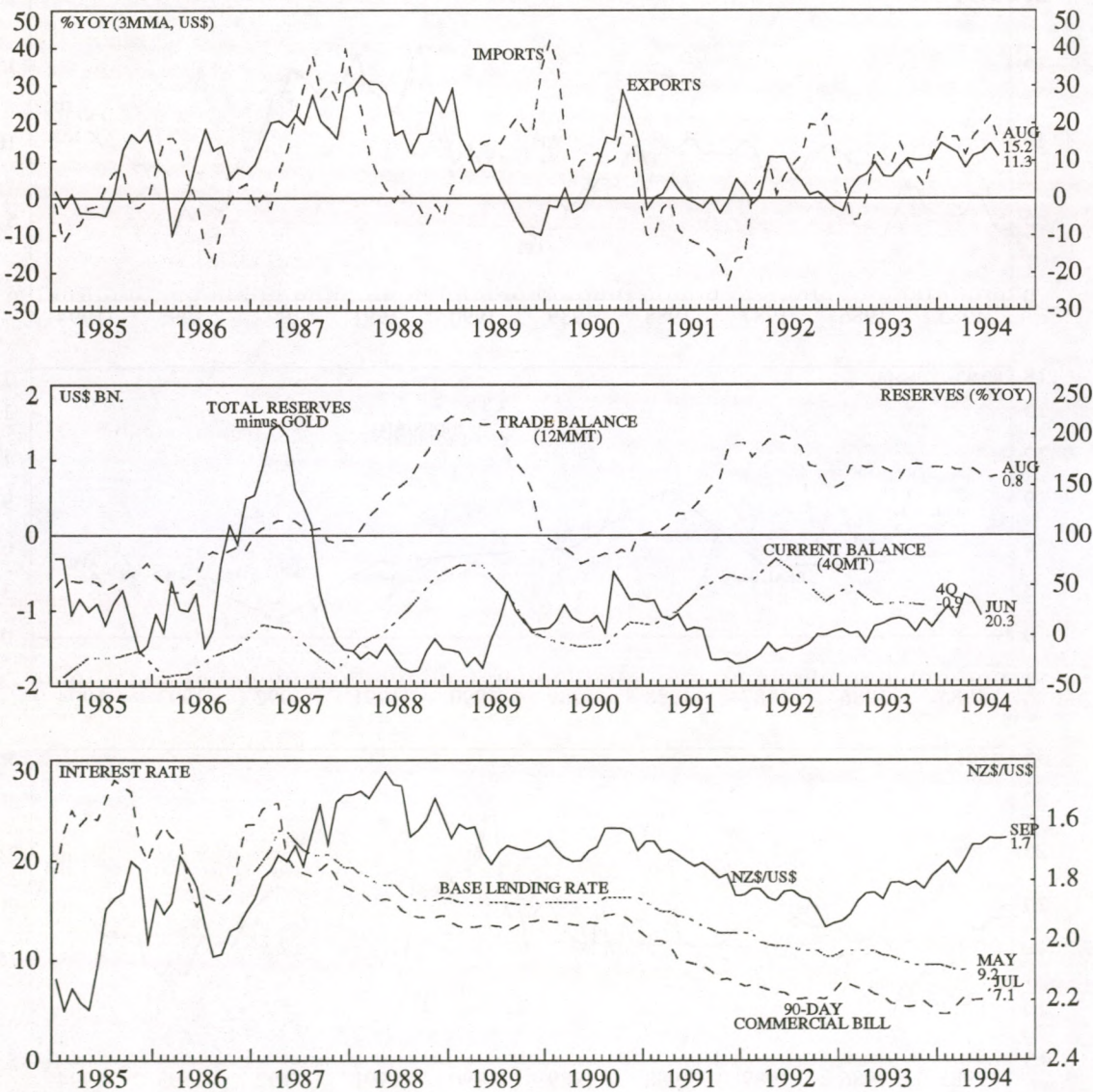
INDIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



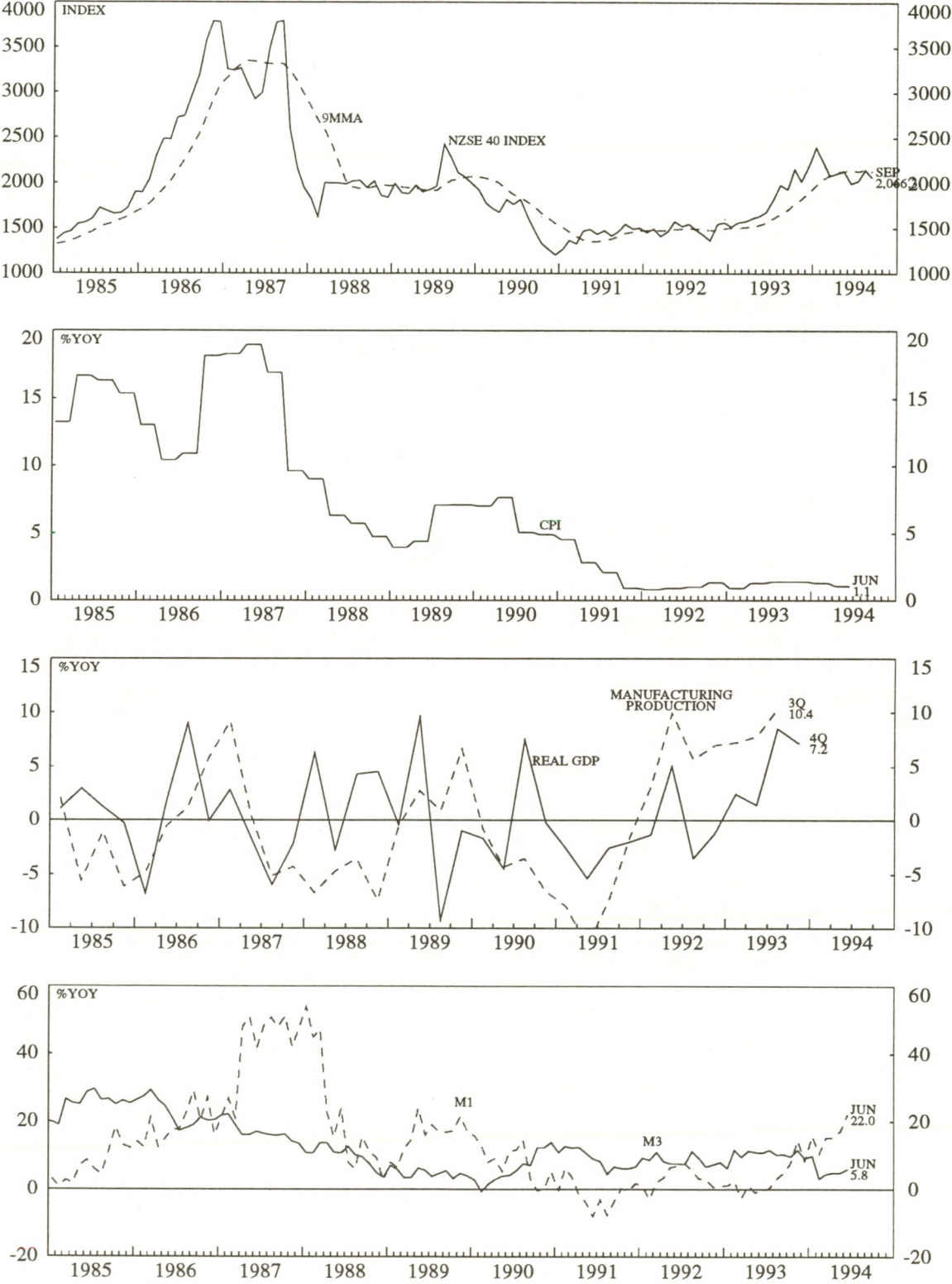
NEW ZEALAND: STRONG GROWTH WITH MONETARY AND FISCAL PRUDENCE

New Zealand is enjoying controlled monetary growth, continued low inflation, central budget surpluses and healthy economic growth. As a member of the dollar bloc of developed economies its long bond prices inherit the trends in their US counterparts. Unlike the RBA in Australia, the hard earned anti-inflationary credibility of the Reserve Bank of New Zealand (RBNZ), has reduced the extent of the back-up in long yields. In addition investors' confidence in the RBNZ upholding its anti-inflation commitment is borne out by one of the flattest yield curves across the entire dollar bloc (with 10 year yields at 9.7 and 90 day rates at 8.3) and by a stable currency. As in Australia, real yields remain too high, but unlike its larger neighbour, inflation will likely remain more subdued.

NEW ZEALAND: MONEY MARKET AND BALANCE OF PAYMENTS



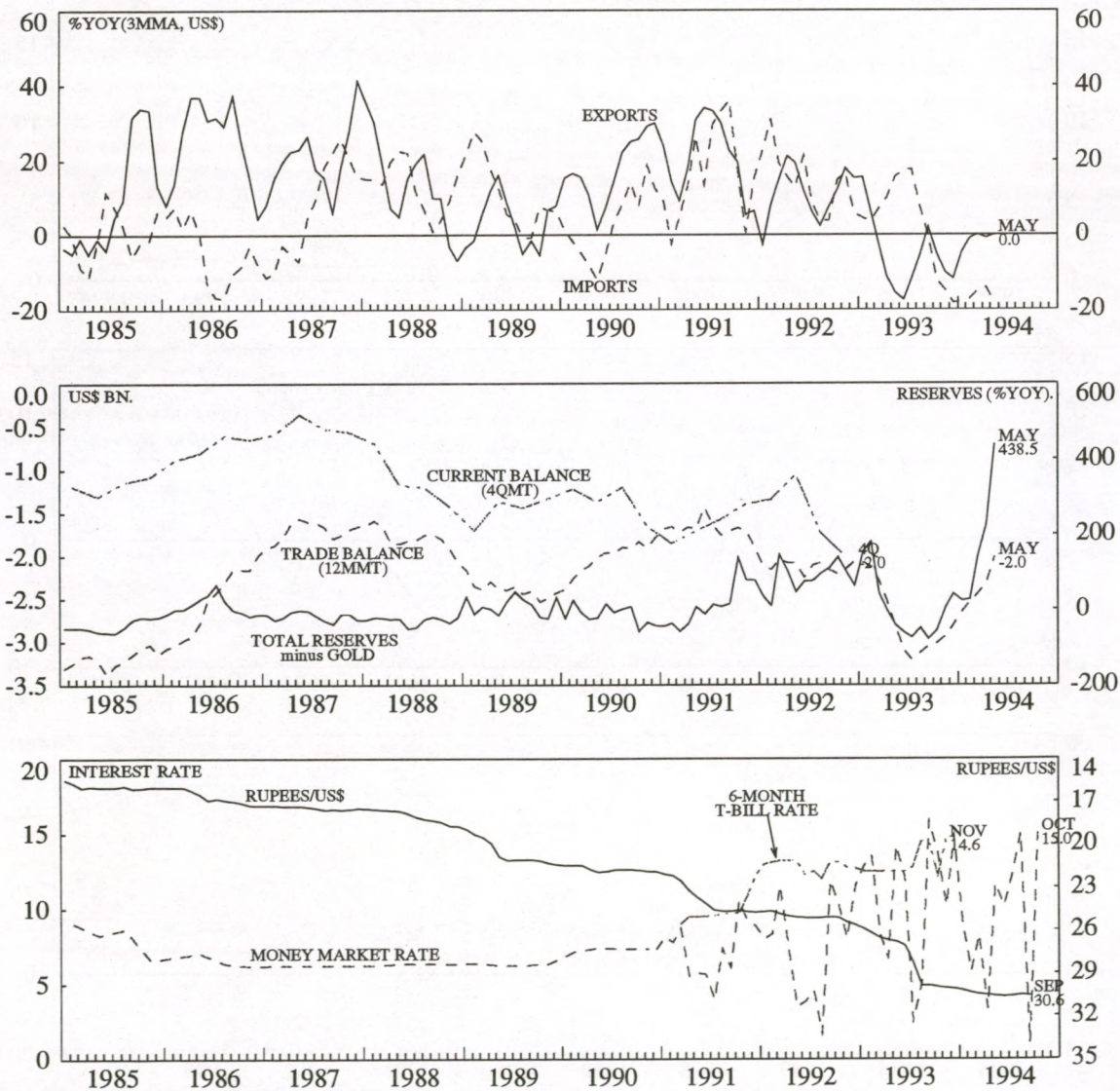
NEW ZEALAND: MONEY, OUTPUT, GOODS AND ASSET PRICES



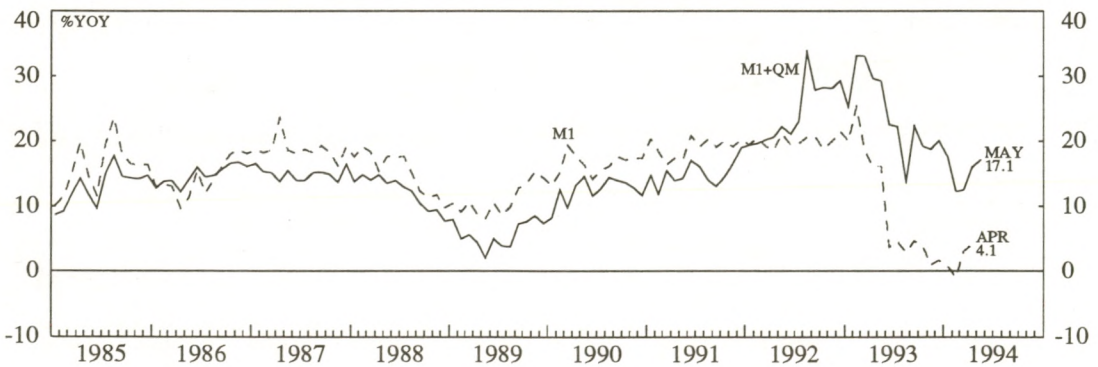
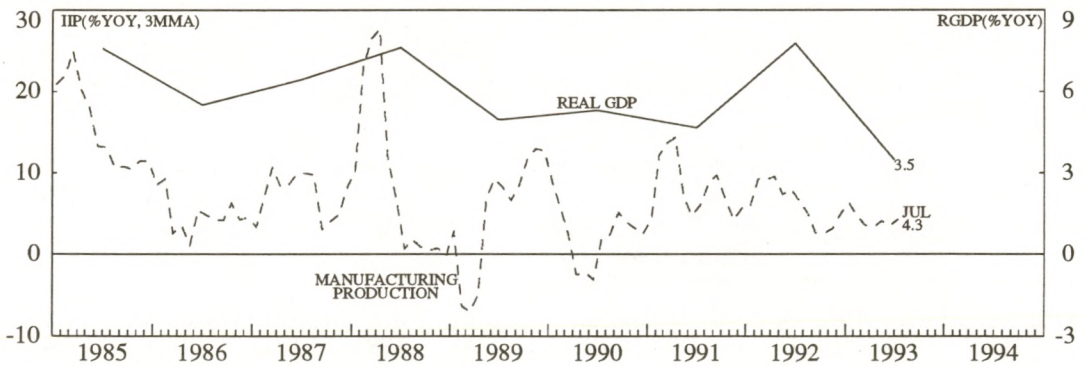
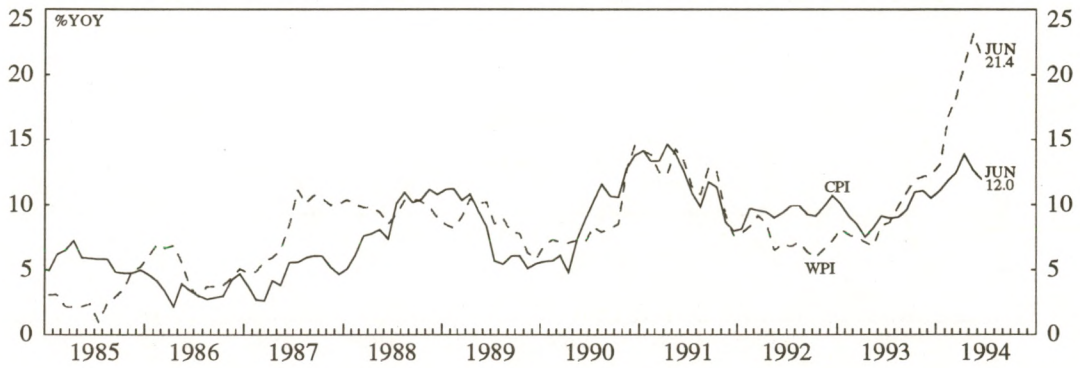
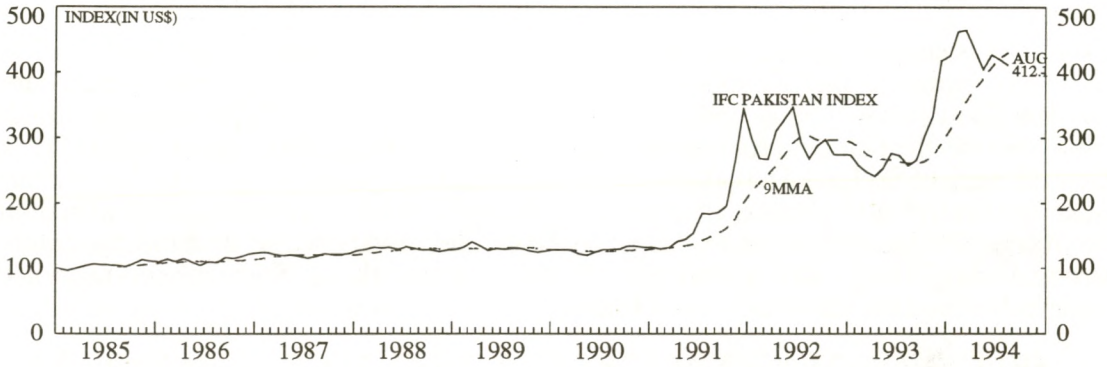
PAKISTAN: POOR EXTERNAL BALANCE CONSTRAINS DOMESTIC ECONOMY

Like India, Pakistan suffers from fiscal overspending. In 1993 the central budget deficit in both these countries as a percentage of GDP was of the order of 7-8%. However, unlike India, Pakistan is suffering from a chronic current account deficit as well (4.7% of GDP in 1993). Cotton (and articles made from it) is a major source of export revenues and a substantial contributor to industrial production. Cotton crop failures over the last couple of years have therefore dealt a severe blow to the economy. Facing an increasing external debt constraint, the government is being forced to cut down on its fiscal commitments. Over the last couple of years the burden of higher public sector financing has contributed to higher local interest rates (and a crowding out of private sector lending) rather than monetisation and higher inflation.

PAKISTAN: MONEY MARKET AND BALANCE OF PAYMENTS



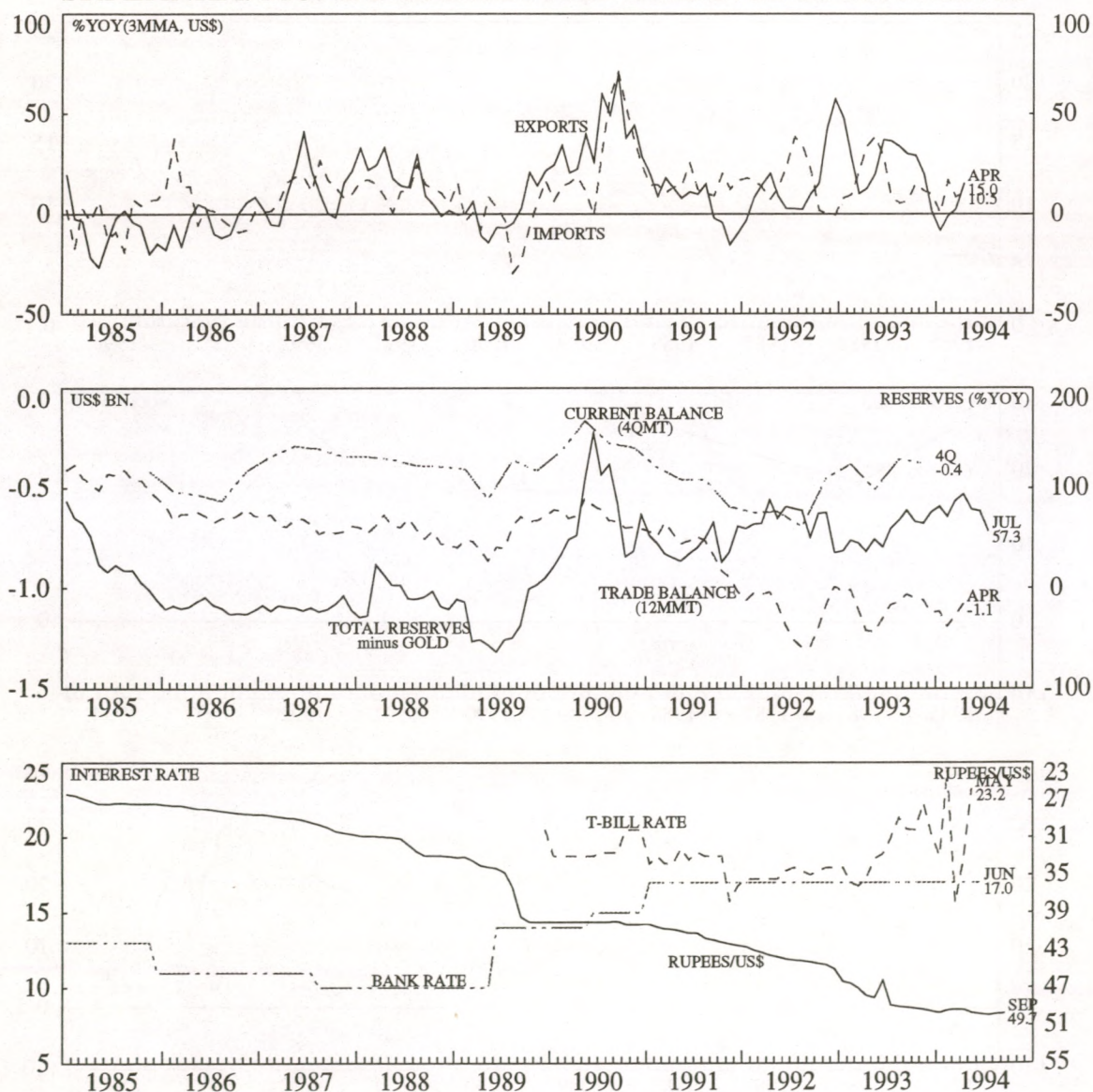
PAKISTAN: MONEY, OUTPUT, GOODS AND ASSET PRICES



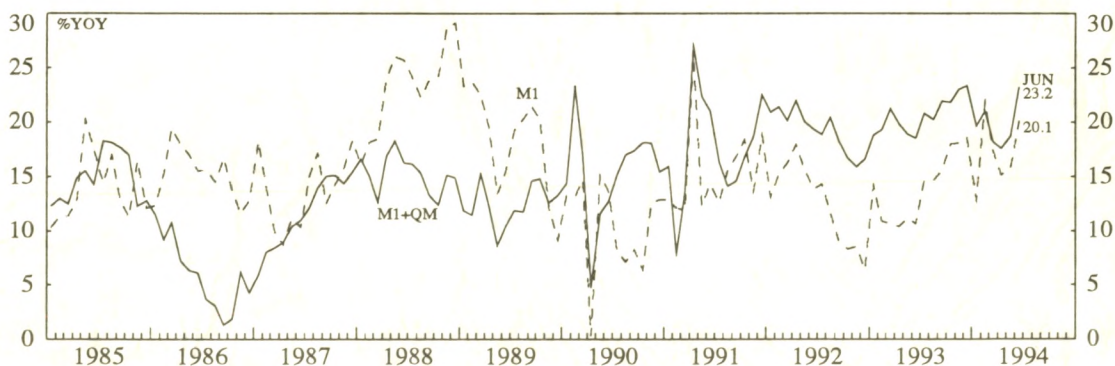
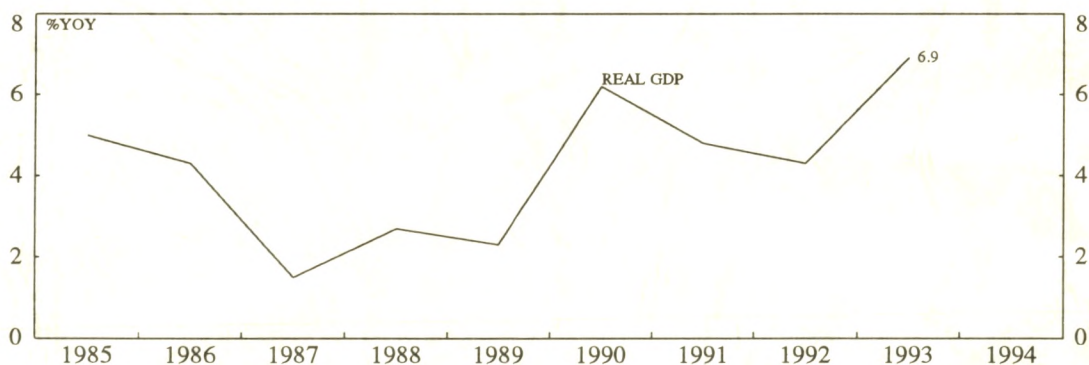
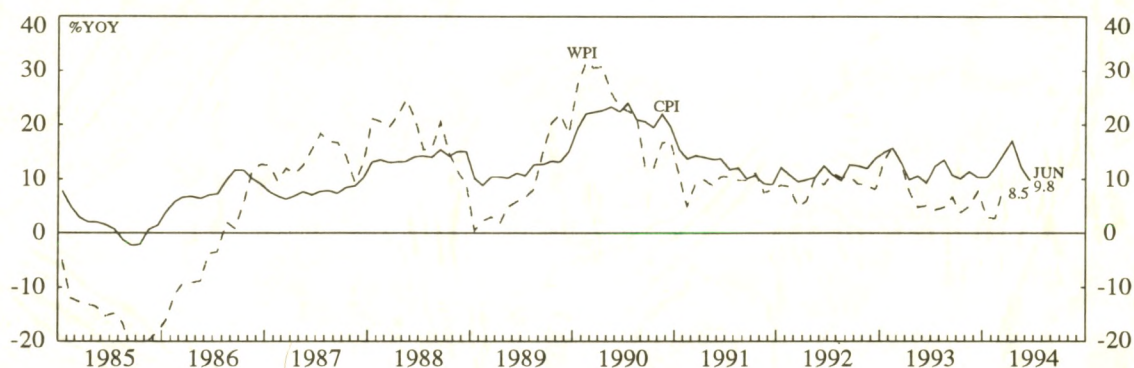
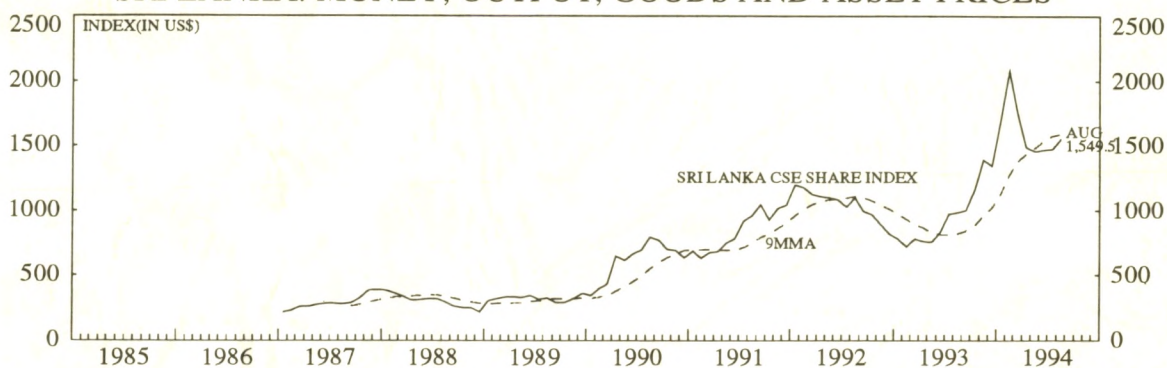
SRI LANKA: STRONGER GROWTH AHEAD

Sri Lanka is similar to India in that it has received a major impetus to domestic credit and monetary growth though a rise in capital inflows in 1993, while the current account deficit has remained stable. Unlike India where banks are burdened with high statutory liquidity ratios there is the potential for the monetary upswing to be much greater in Sri Lanka. The Central Bank of Sri Lanka has attempted to deal with this by sterilising its foreign exchange intervention over the last year (by borrowing from the banks). However, notwithstanding the recent decline in foreign exchange reserves, the private sector demand for credit is strong, underpinning a strengthening economy in the year ahead. Some deterioration in the trade deficit and higher inflation will follow.

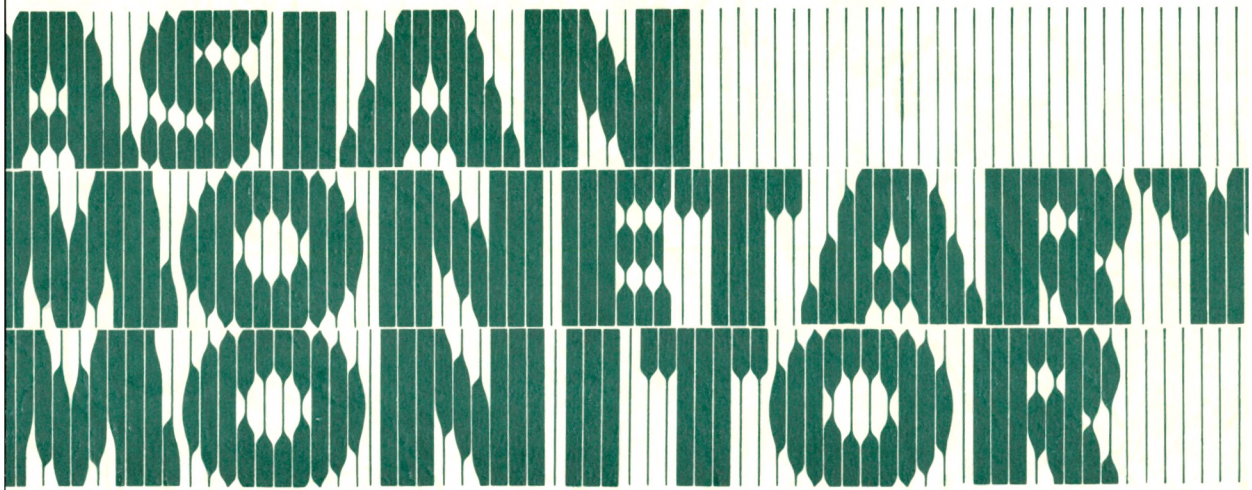
SRI LANKA: MONEY MARKET AND BALANCE OF PAYMENTS



SRI LANKA: MONEY, OUTPUT, GOODS AND ASSET PRICES







CONTENTS

	Page
CHINA	
Higher Inflation Prompts Further Restraint by Philip Wyatt	1
HONG KONG	
Little Upside for Asset Prices by Jakob Lund	8
JAPAN	
A Consumer-led, Deflationary Recovery by John Greenwood	14
PHILIPPINES	
Higher Interest Rates Ahead by Philip Wyatt	20
SINGAPORE	
Inflationary Pressures Prompt Faster S\$ Appreciation by Jakob Lund	25





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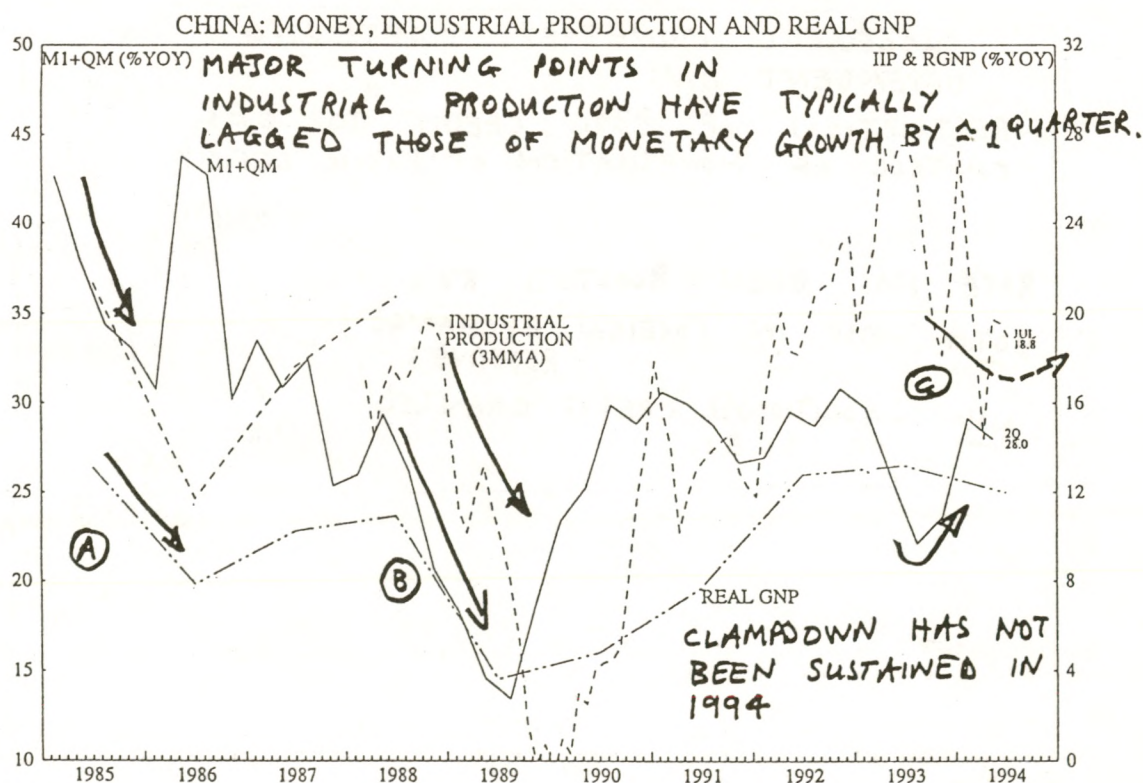
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September-October 1994

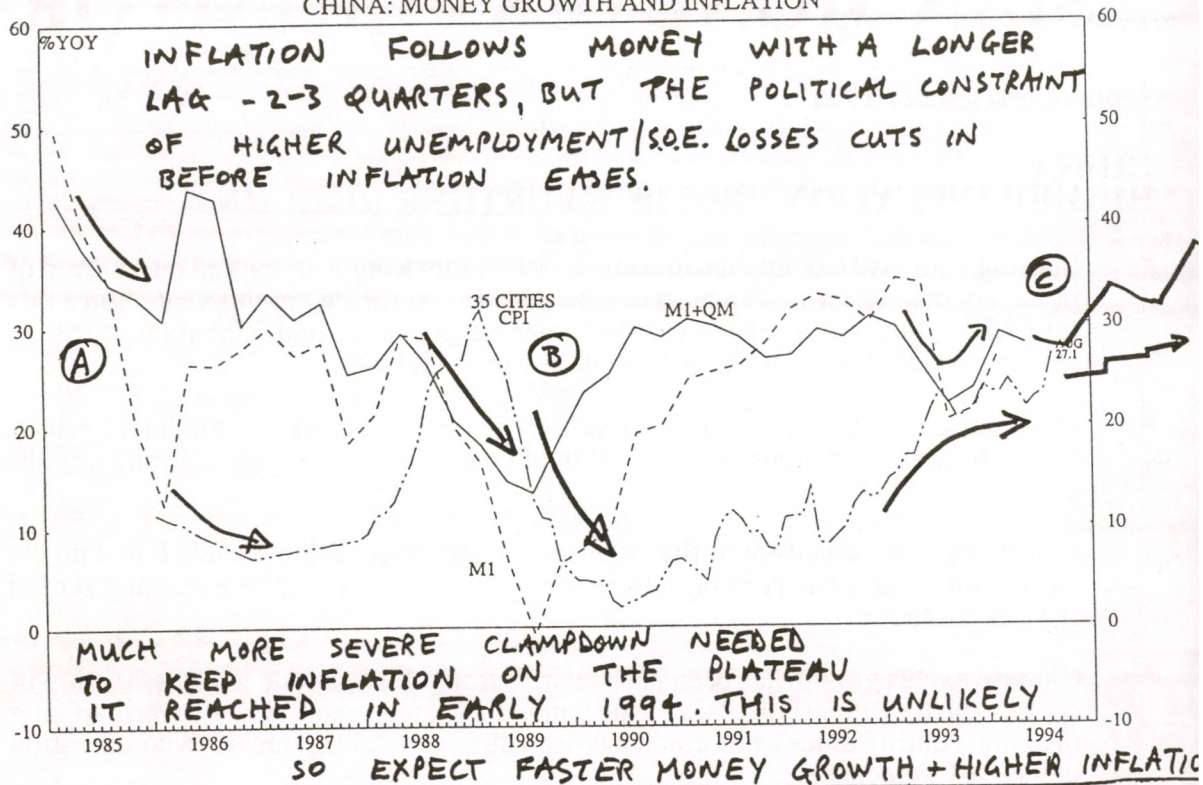
Vol. 18 No.5

CHINA HIGHER INFLATION PROMPTS FURTHER RESRAINT

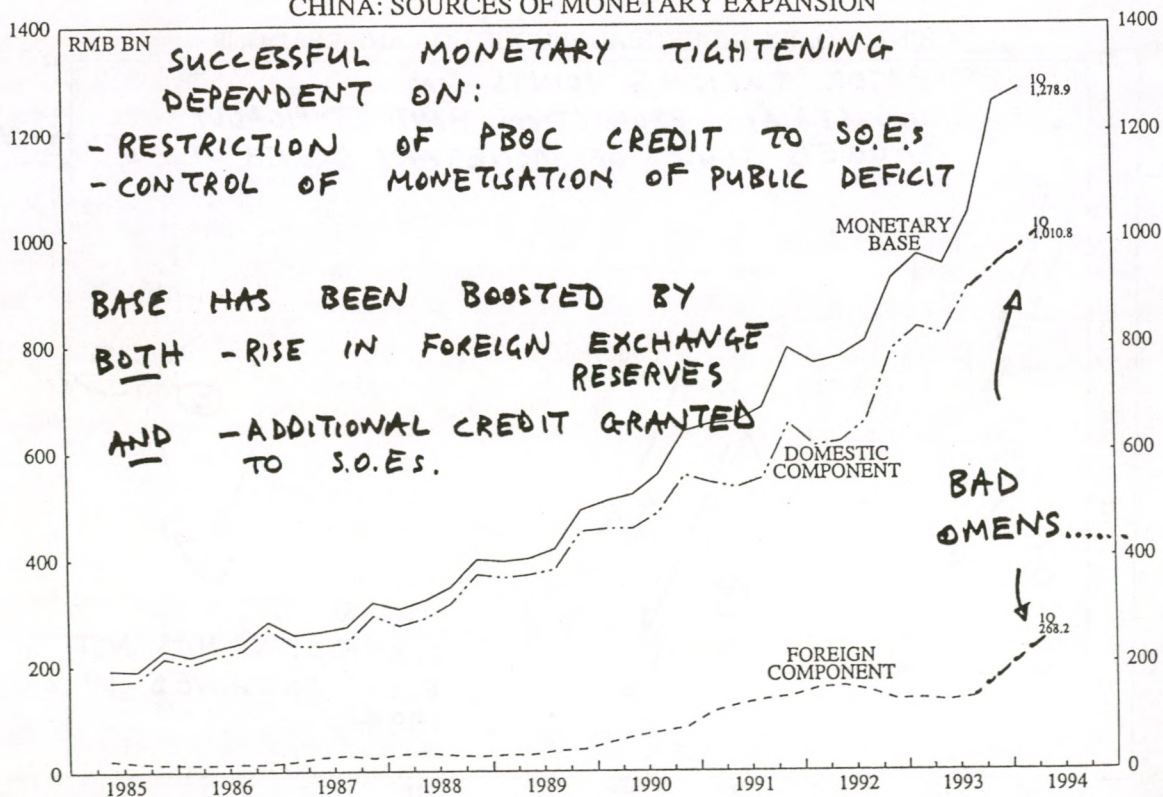
- * Starting with his 16 point plan in Autumn 1993, Zhu Rongji embarked on a period of monetary restraint which appears to have lasted to April/May of this year. Since this time M1+QM has reaccelerated: a bad omen suggesting recent relaxation of PBOC lending to state banks and higher inflation rates in 2H 94.
- * However, combating inflation remains high on the authorities' current list of priorities so further restrictions on availability of credit are to be expected in the months ahead.
- * Growth in state-owned enterprises investment and retail sales, which in line with the austerity measures had been on a decelerating 9-12 month trend have recently started to buck this trend.
- * Chinese export growth has been particularly strong this year due to (1) relaxation of controls on the proportion of domestic output that can be exported, (2) overinvoicing of exports during times when credit has been difficult to obtain and (3) a continuation in the OECD recovery.



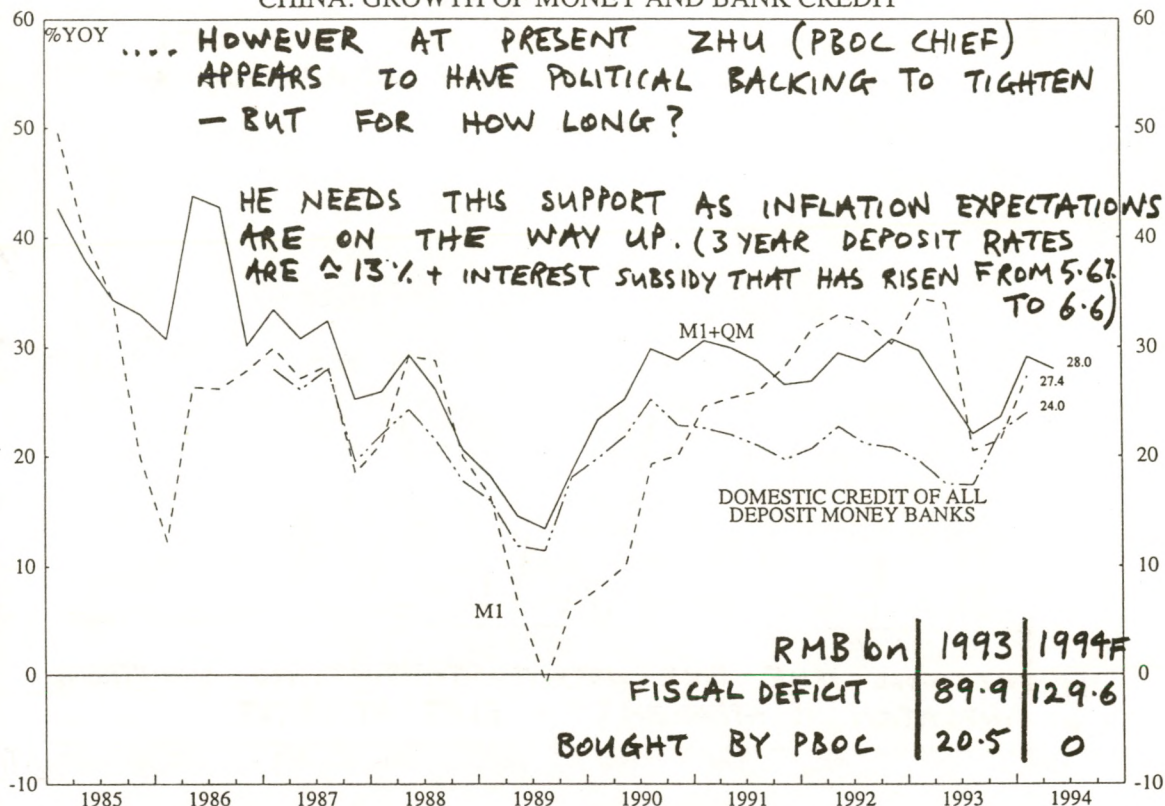
CHINA: MONEY GROWTH AND INFLATION



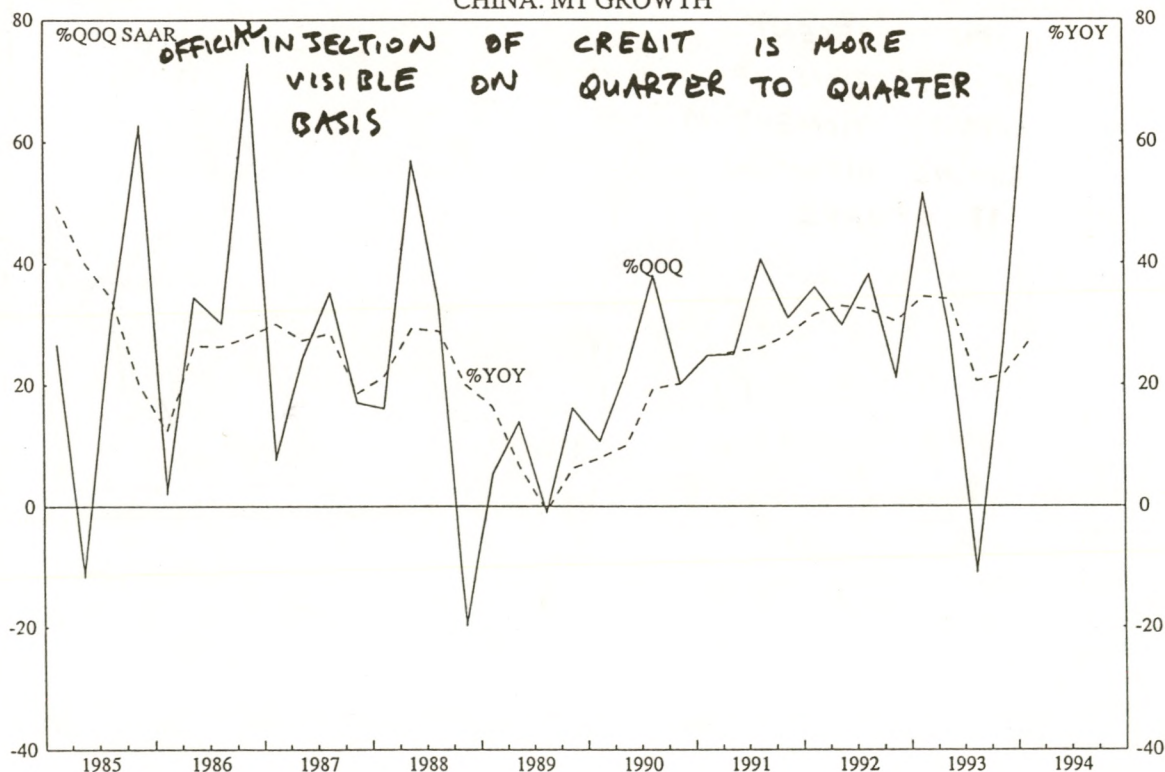
CHINA: SOURCES OF MONETARY EXPANSION



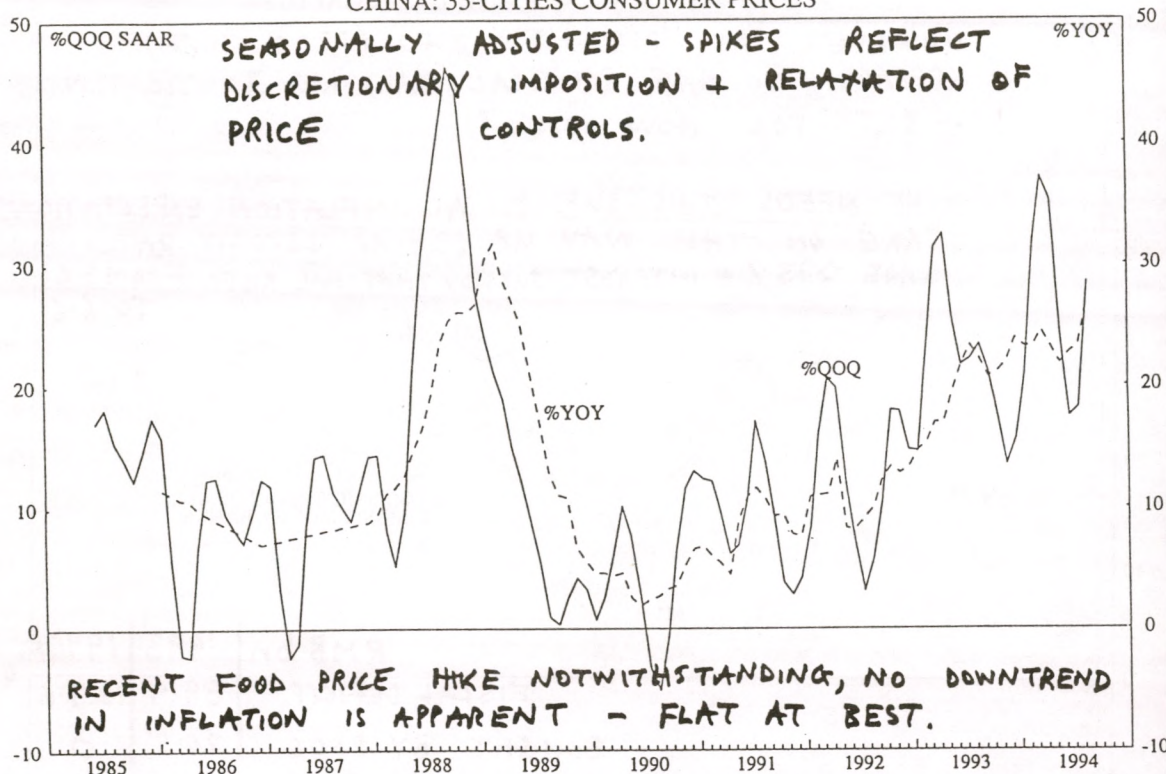
CHINA: GROWTH OF MONEY AND BANK CREDIT



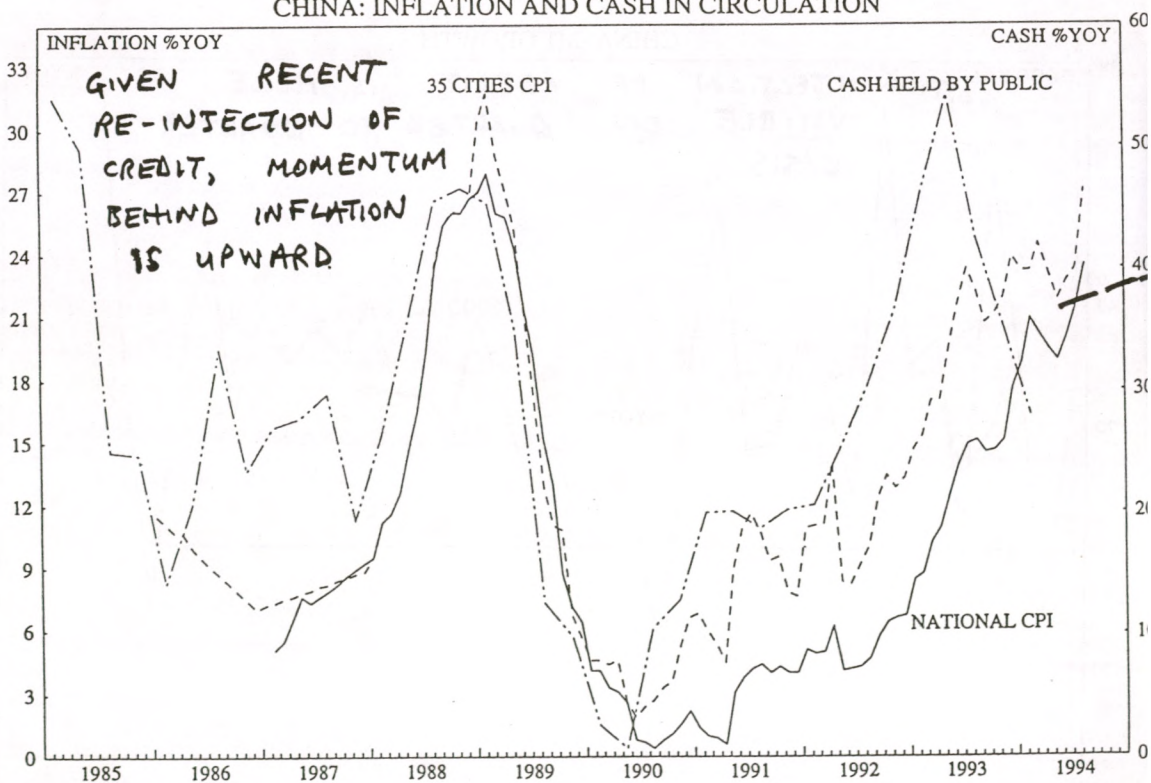
CHINA: M1 GROWTH



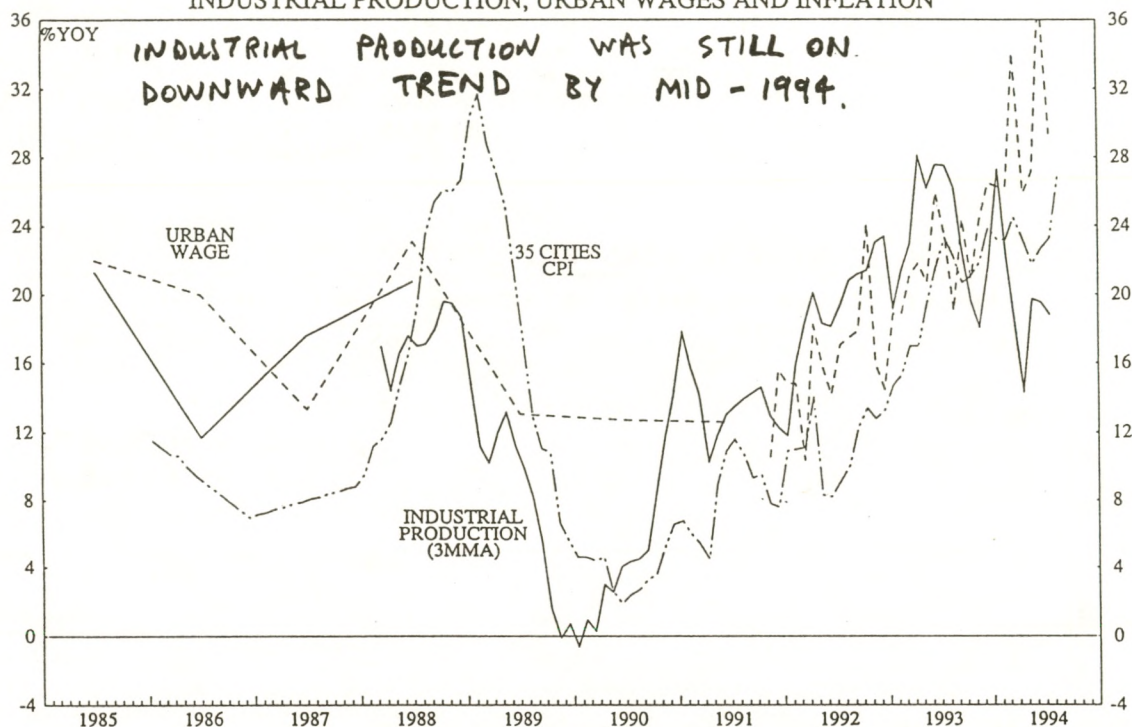
CHINA: 35-CITIES CONSUMER PRICES



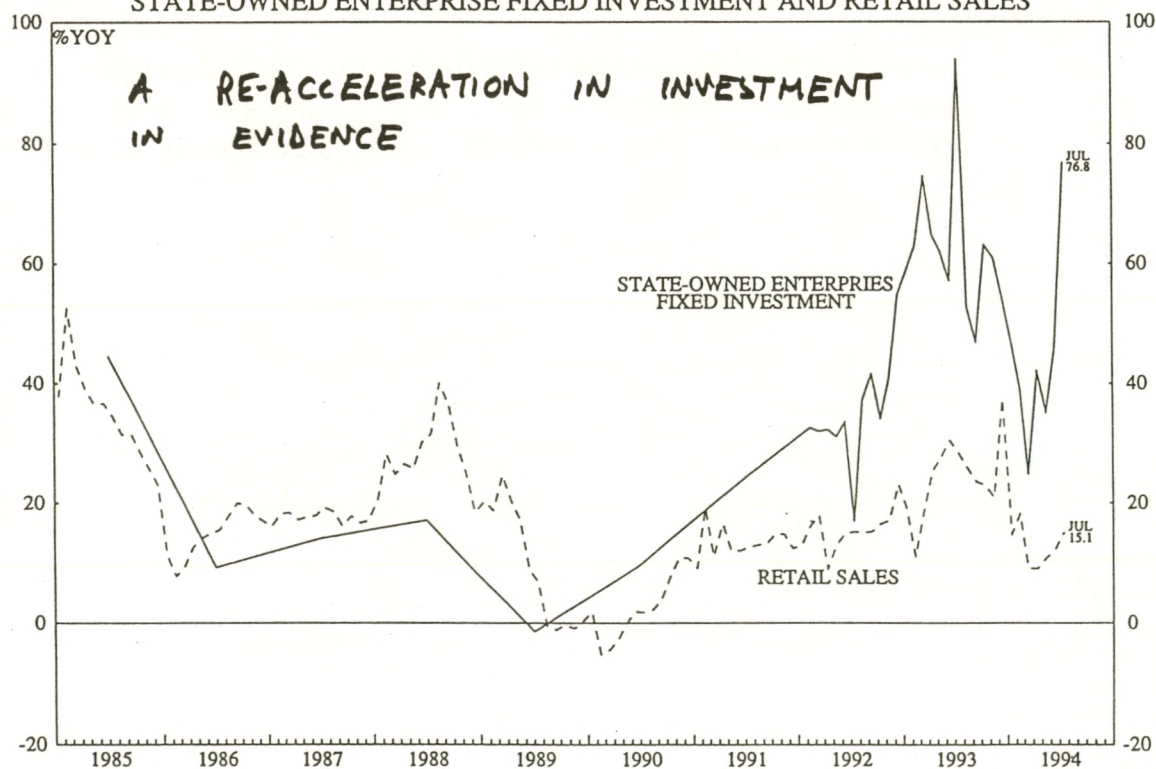
CHINA: INFLATION AND CASH IN CIRCULATION



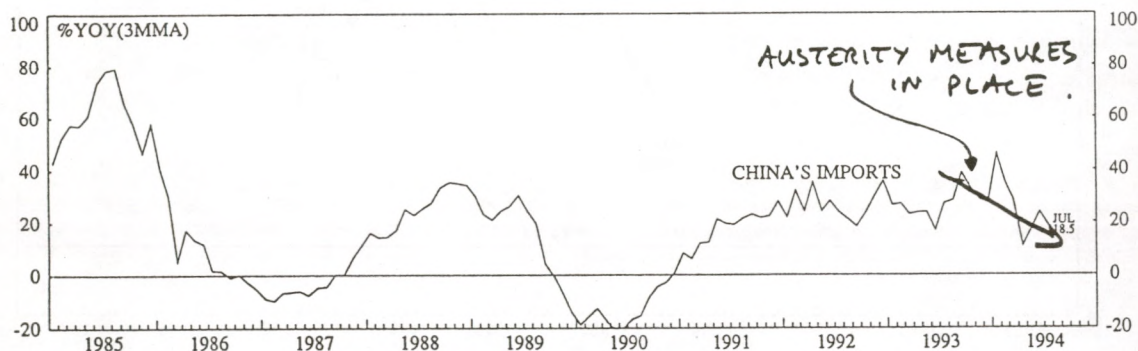
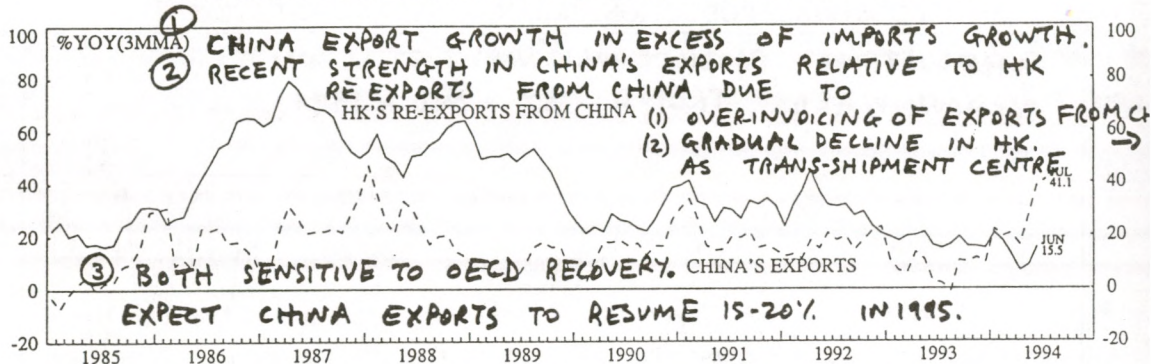
CHINA INDUSTRIAL PRODUCTION, URBAN WAGES AND INFLATION



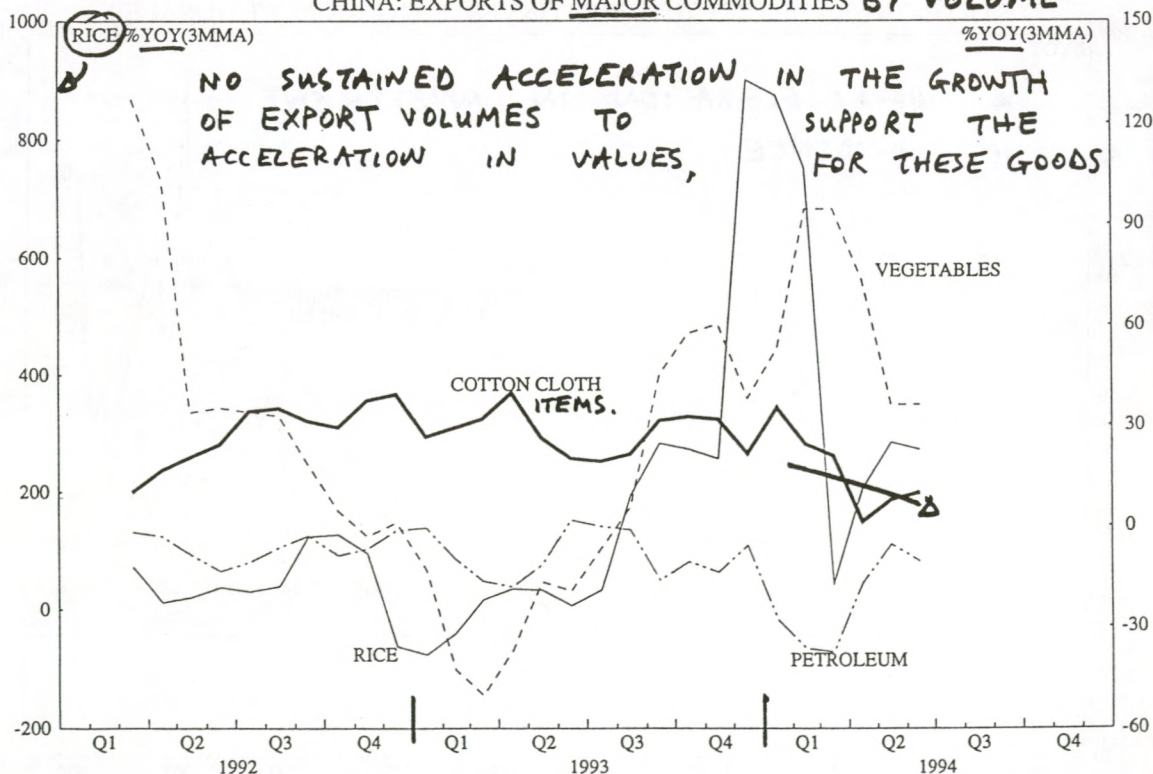
CHINA STATE-OWNED ENTERPRISE FIXED INVESTMENT AND RETAIL SALES



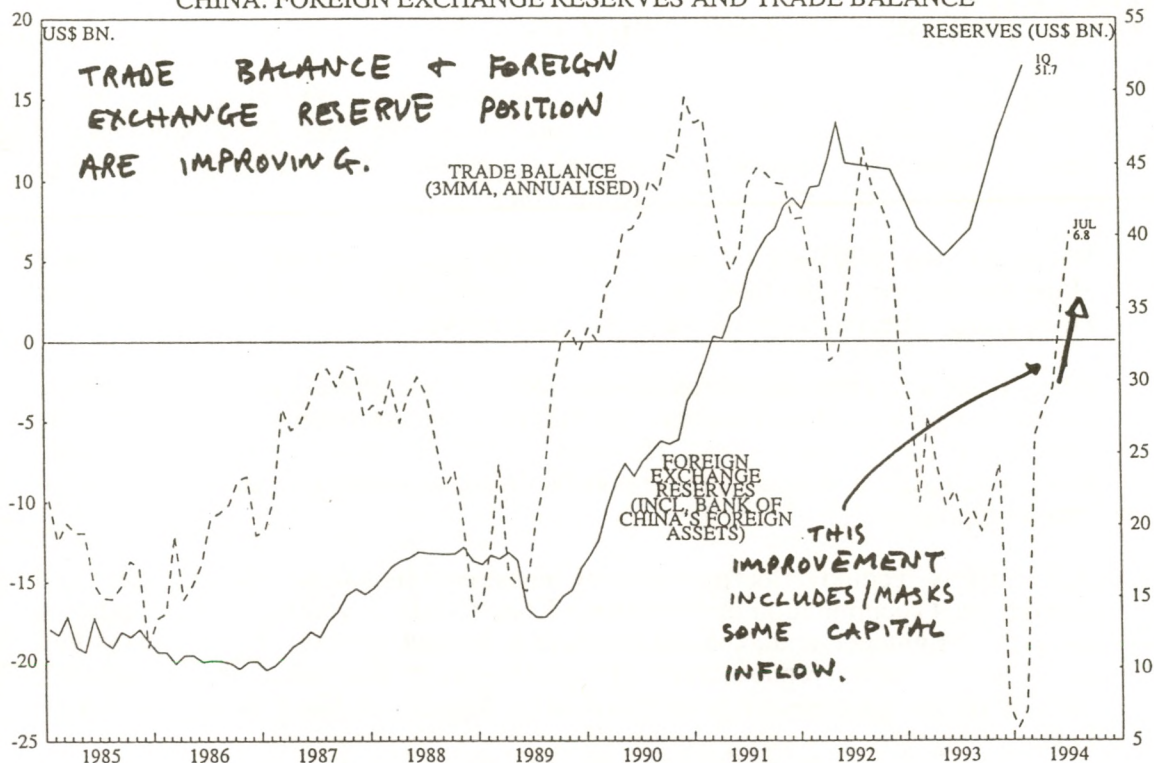
HONG KONG'S RE-EXPORTS TRADE WITH CHINA & CHINA'S TRADE



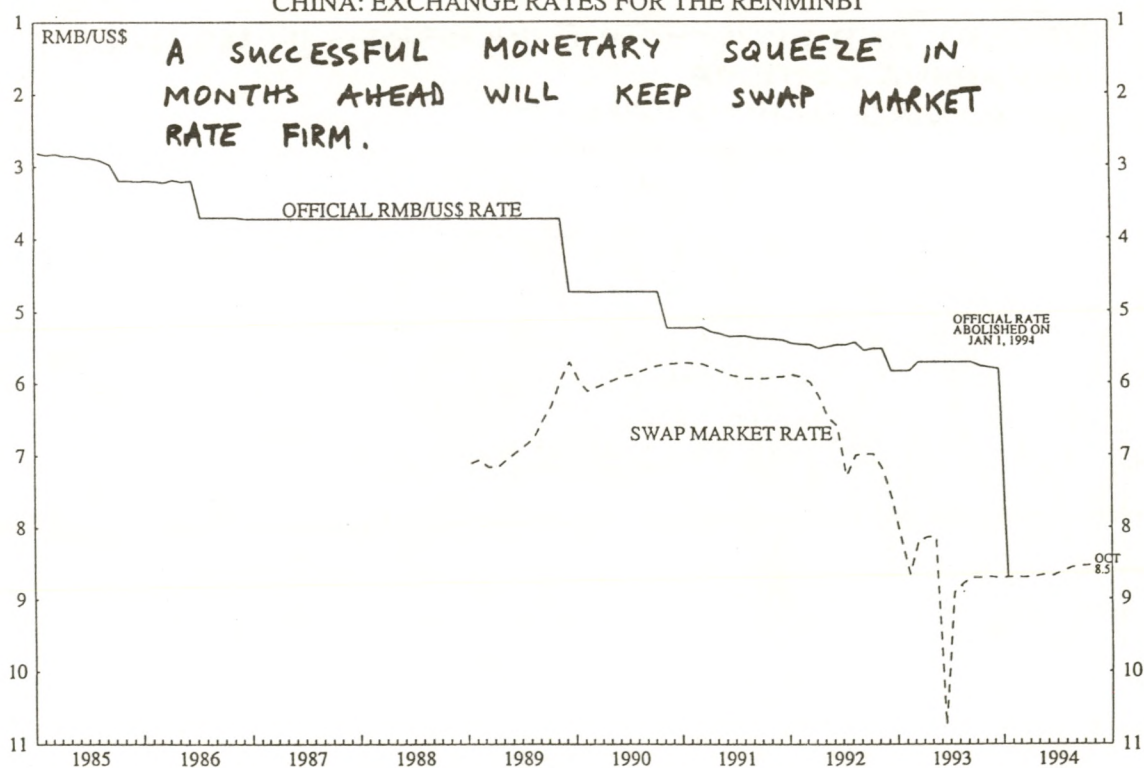
CHINA: EXPORTS OF MAJOR COMMODITIES BY VOLUME



CHINA: FOREIGN EXCHANGE RESERVES AND TRADE BALANCE

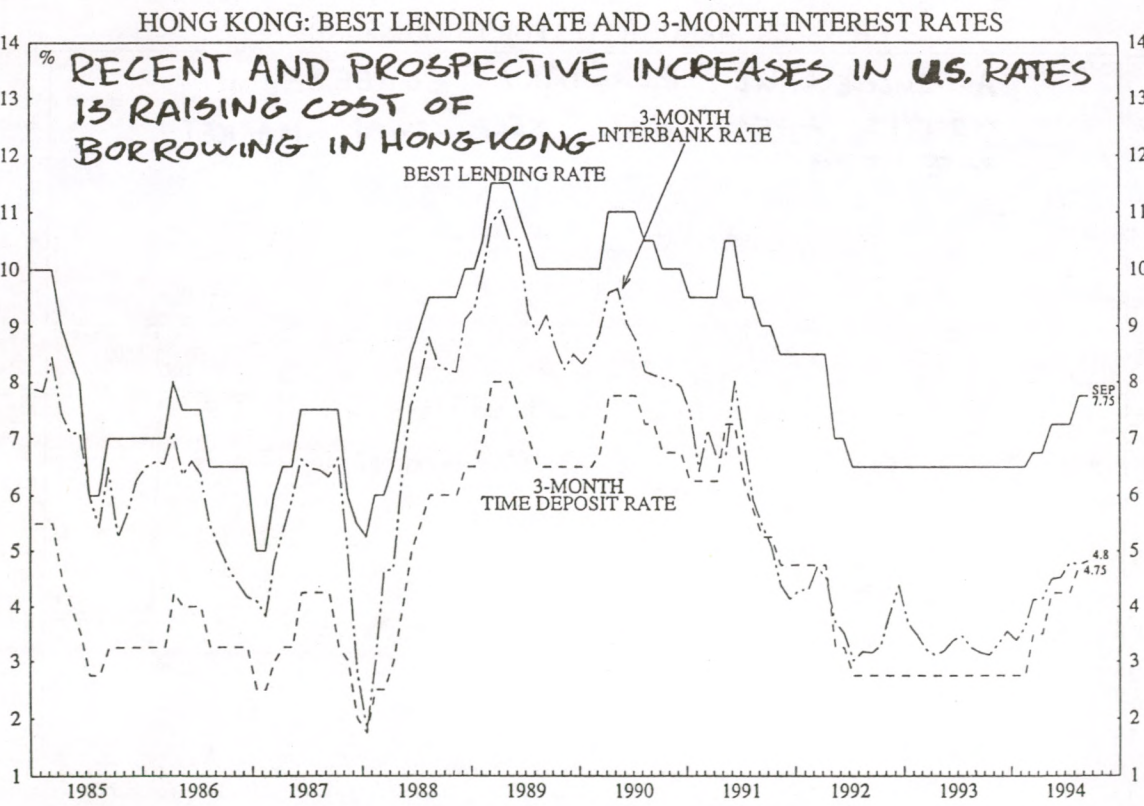


CHINA: EXCHANGE RATES FOR THE RENMINBI

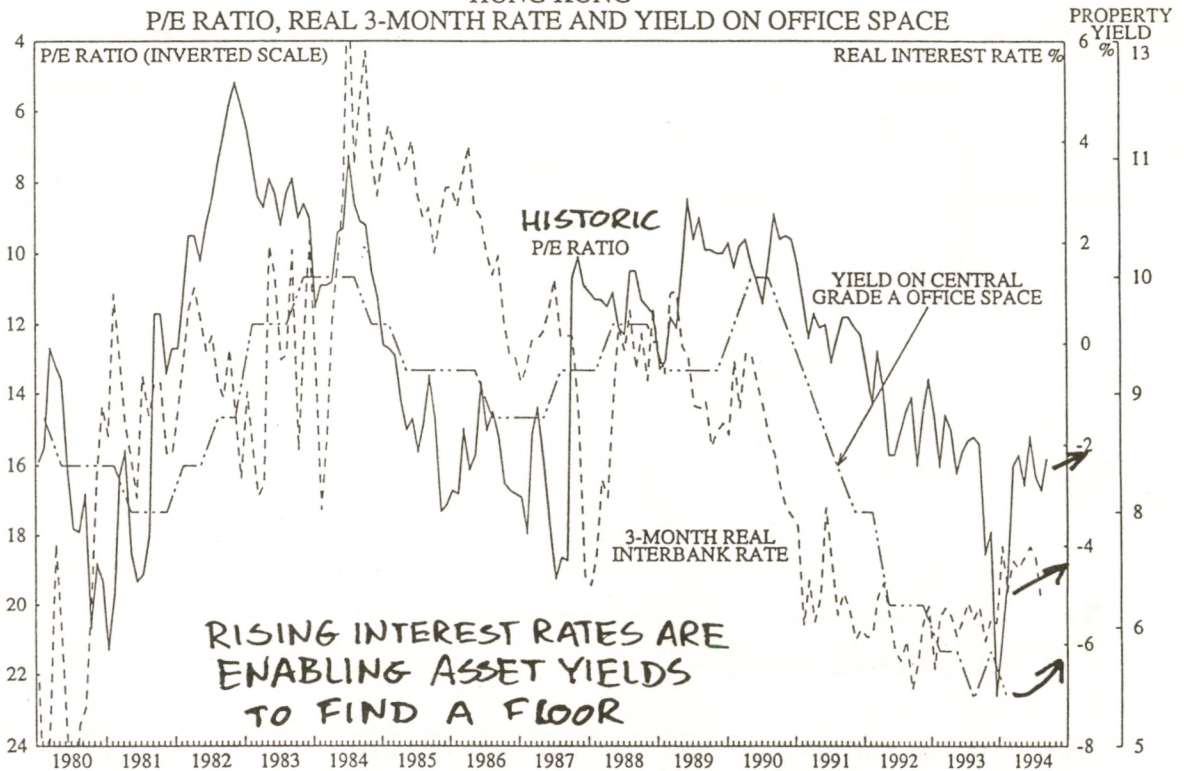


HONG KONG LITTLE UPSIDE FOR ASSET PRICES

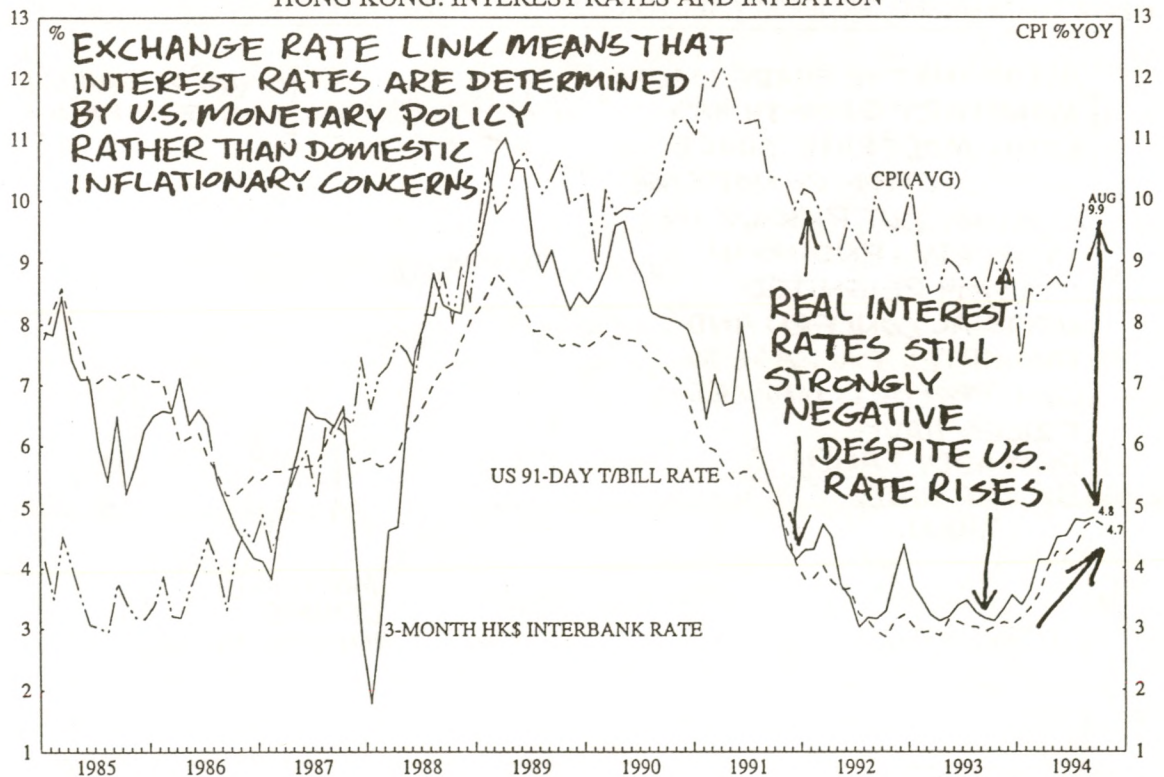
- * Hong Kong's asset prices have been pushed up in recent years by three main sources of liquidity: outflows from the US due to low interest rates there (until February this year), availability of credit at negative real interest rates in Hong Kong, and savings from China seeking a safe haven in Hong Kong.
- * Because of the US\$/HK\$ link future rises in US interest rates will cause equivalent Hong Kong interest rates to rise in tandem. As a result the outlook for asset prices in Hong Kong is becoming progressively less attractive.
- * Hong Kong's re-exports (approximately 75% of total exports and previously the main driving force behind economic growth) have been surprisingly subdued in spite of accelerating Chinese exports. This may reflect port capacity constraints in Hong Kong and a switch to new Chinese port facilities, or a switch from "re-exports" to "trans-shipments".
- * Alternatively, it could reflect a switch by Chinese exporters from transfer-pricing and foreign asset accumulation through Hong Kong to fully invoicing for their exports, as credit is tightened and expenditures have to be met from revenues. This would effectively be capital repatriation via the trade account, and would imply a negative outlook for the Chinese component of foreign liquidity in Hong Kong's asset markets.



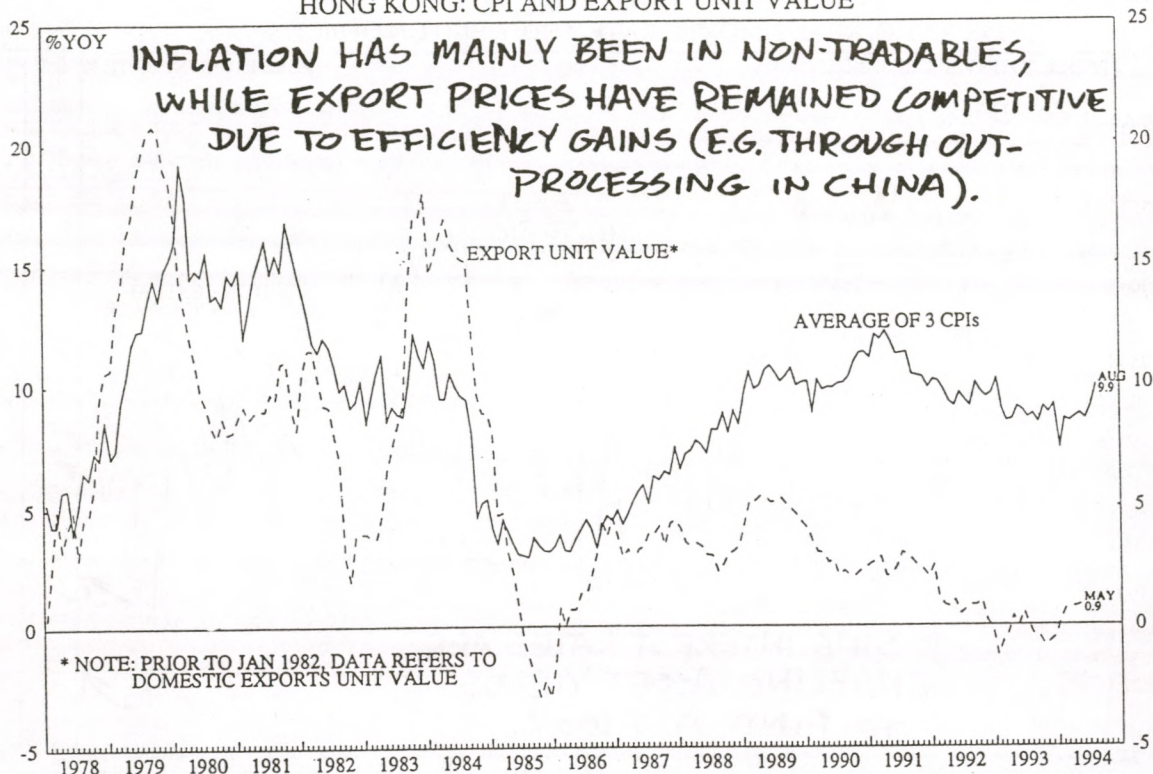
HONG KONG P/E RATIO, REAL 3-MONTH RATE AND YIELD ON OFFICE SPACE



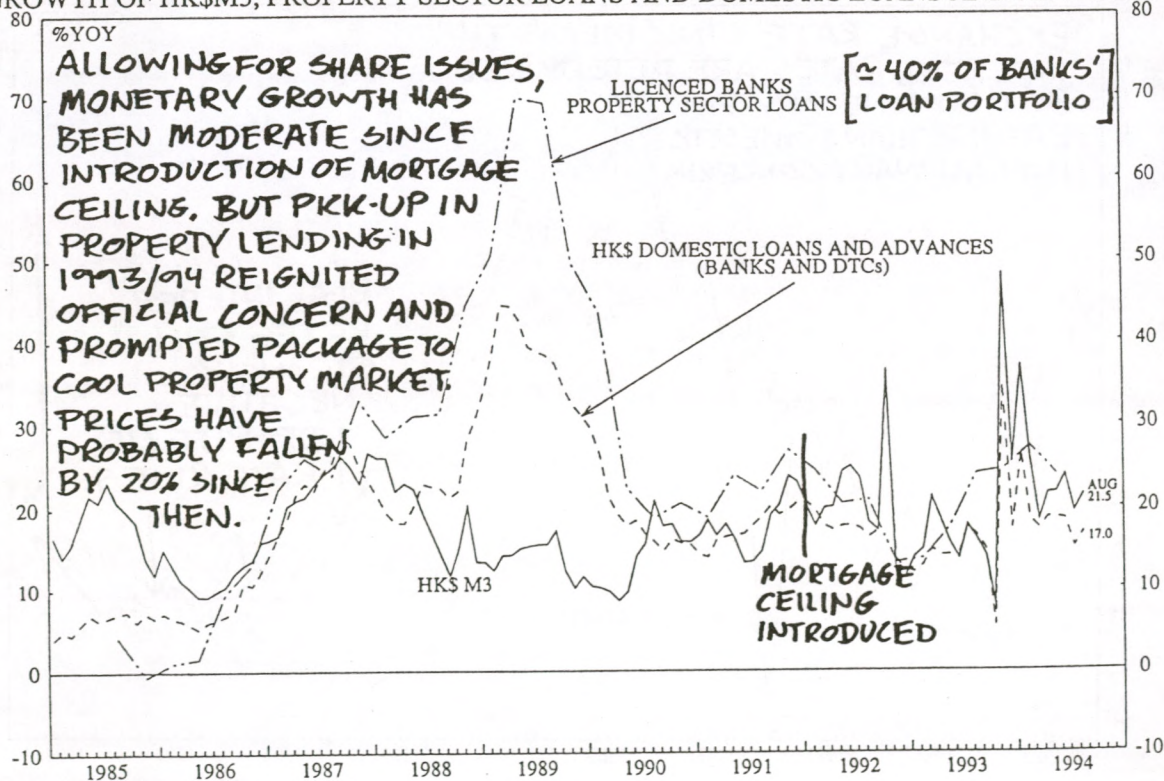
HONG KONG: INTEREST RATES AND INFLATION



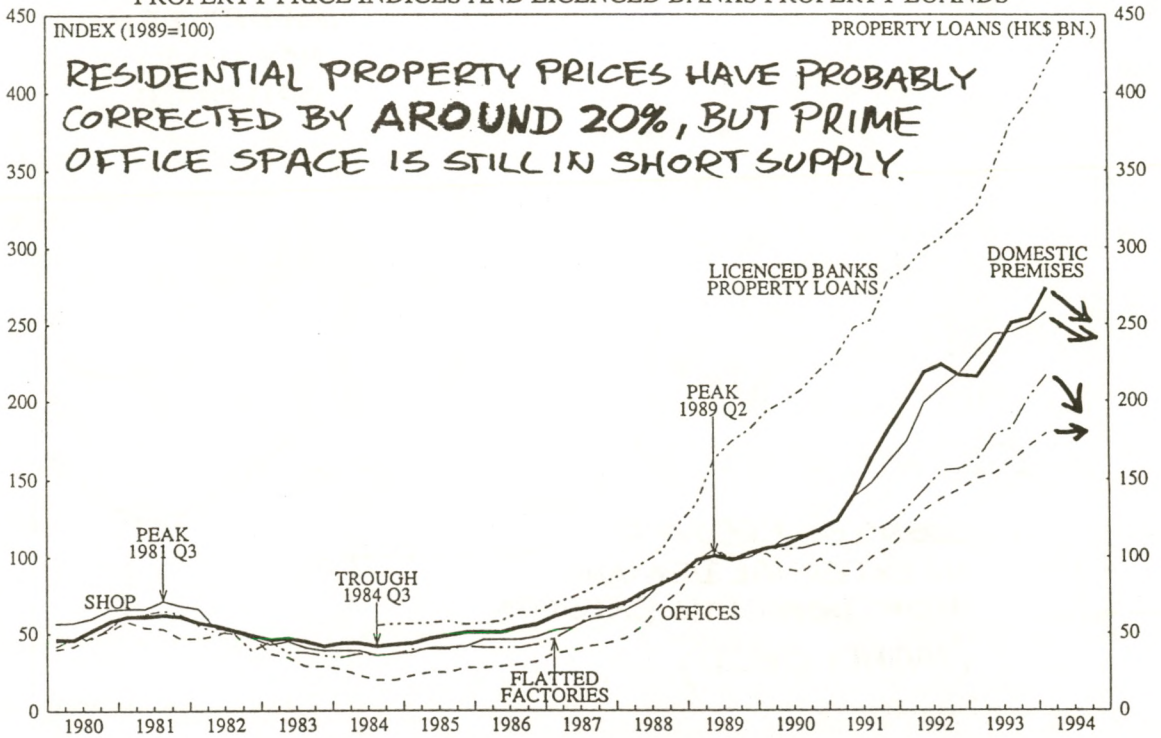
HONG KONG: CPI AND EXPORT UNIT VALUE



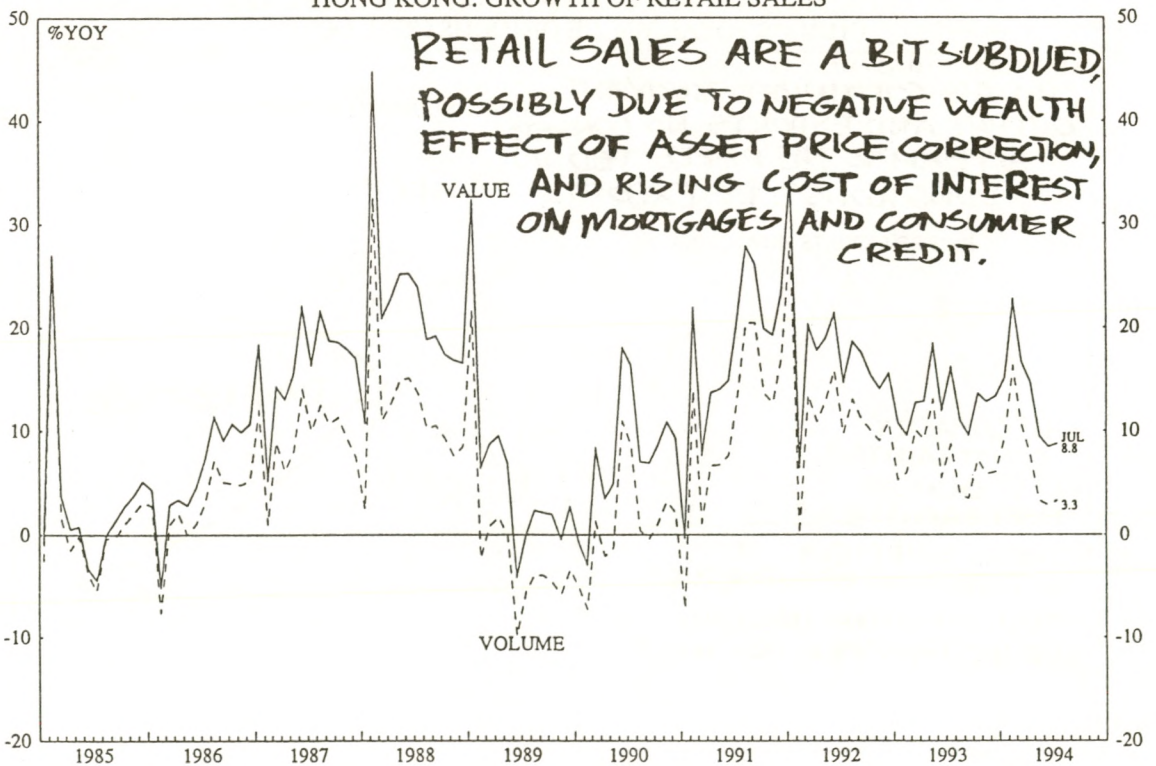
HONG KONG GROWTH OF HK\$M3, PROPERTY SECTOR LOANS AND DOMESTIC LOANS AND ADVANCES



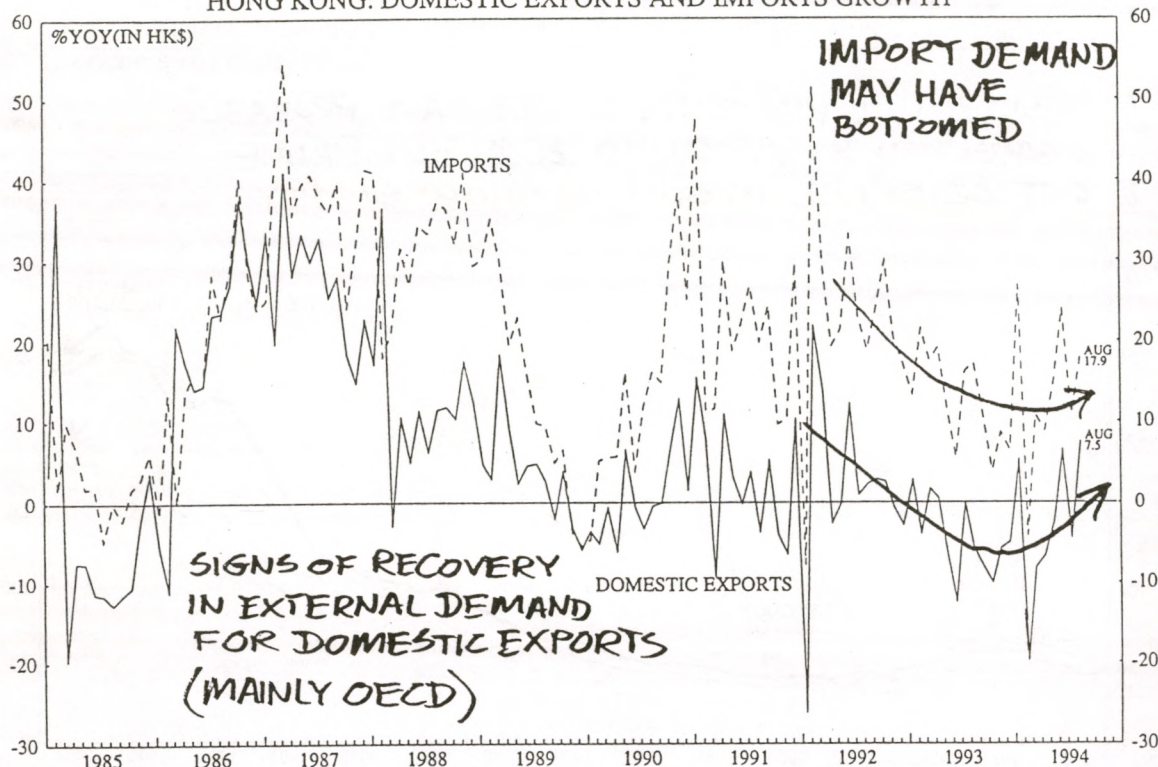
HONG KONG PROPERTY PRICE INDICES AND LICENCED BANKS PROPERTY LOANS



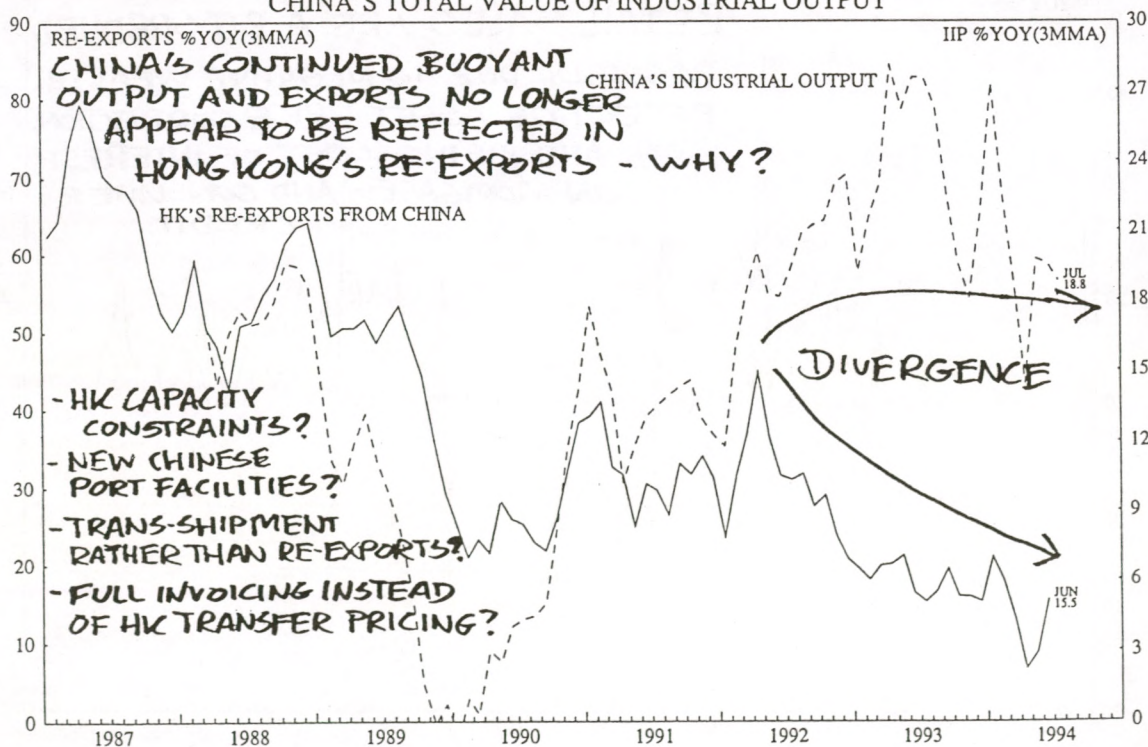
HONG KONG: GROWTH OF RETAIL SALES



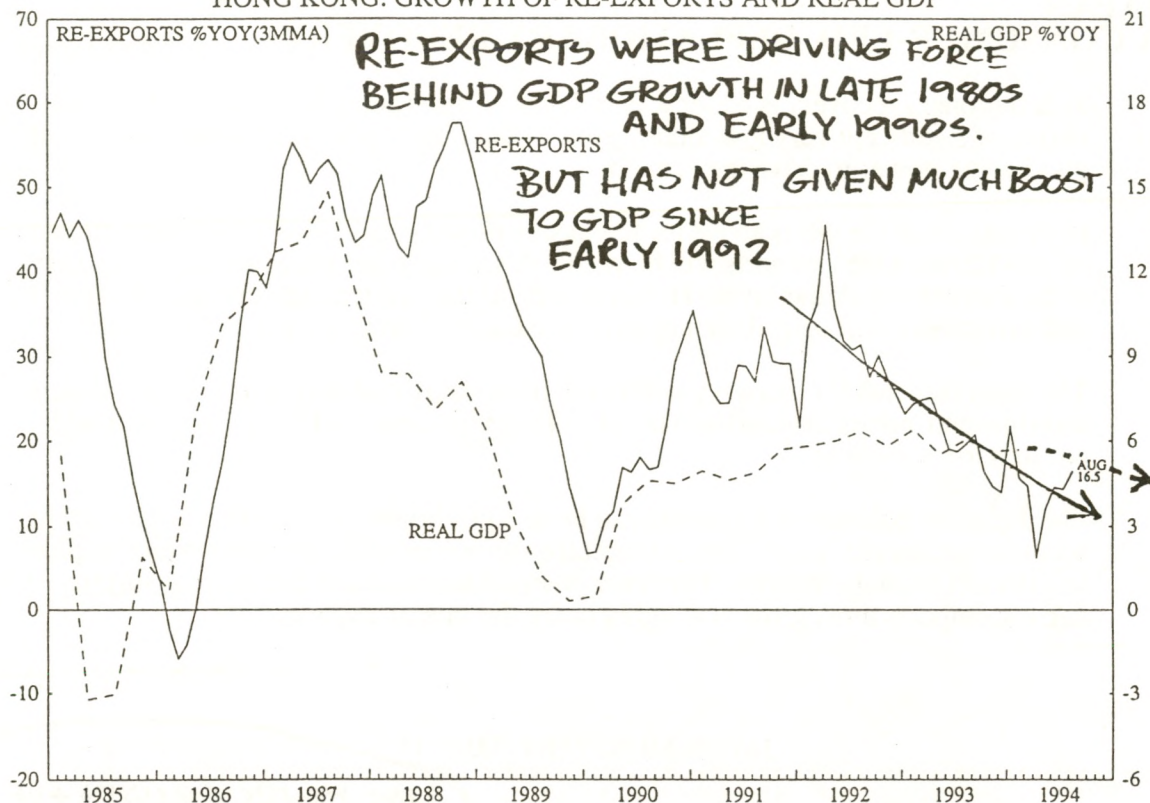
HONG KONG: DOMESTIC EXPORTS AND IMPORTS GROWTH



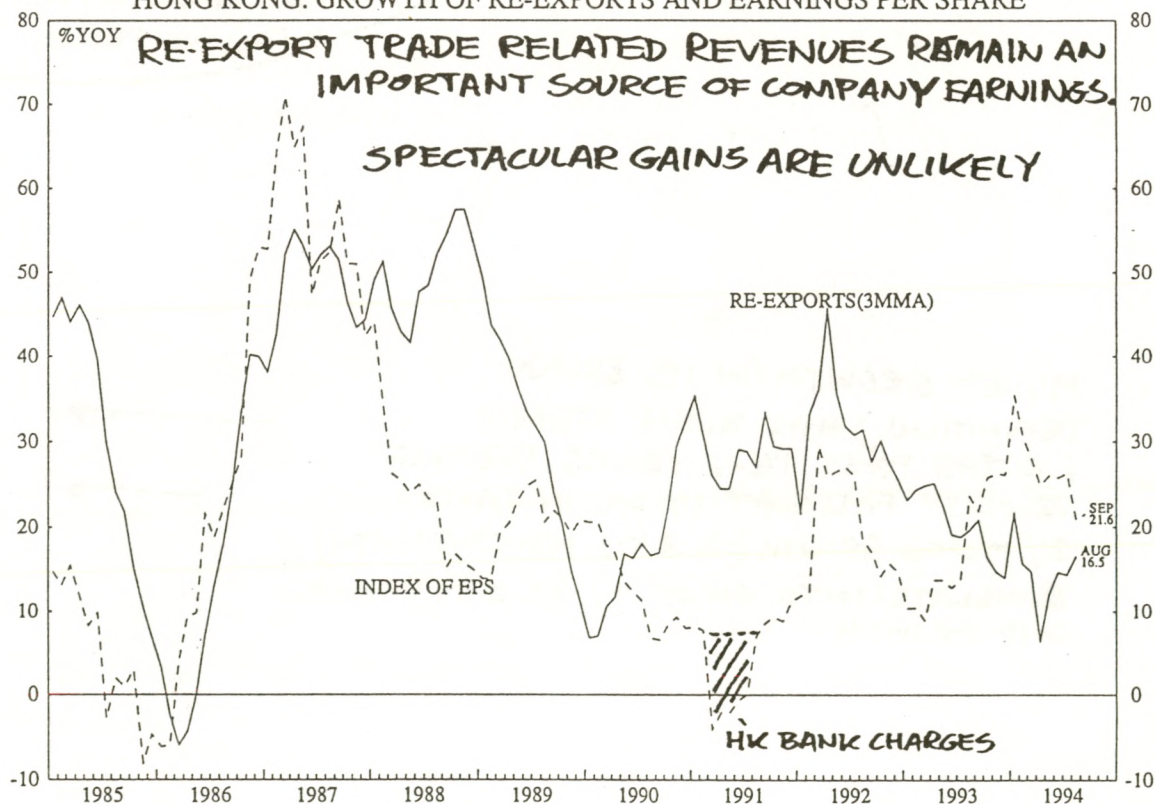
HONG KONG'S RE-EXPORTS TRADE WITH CHINA AND CHINA'S TOTAL VALUE OF INDUSTRIAL OUTPUT



HONG KONG: GROWTH OF RE-EXPORTS AND REAL GDP

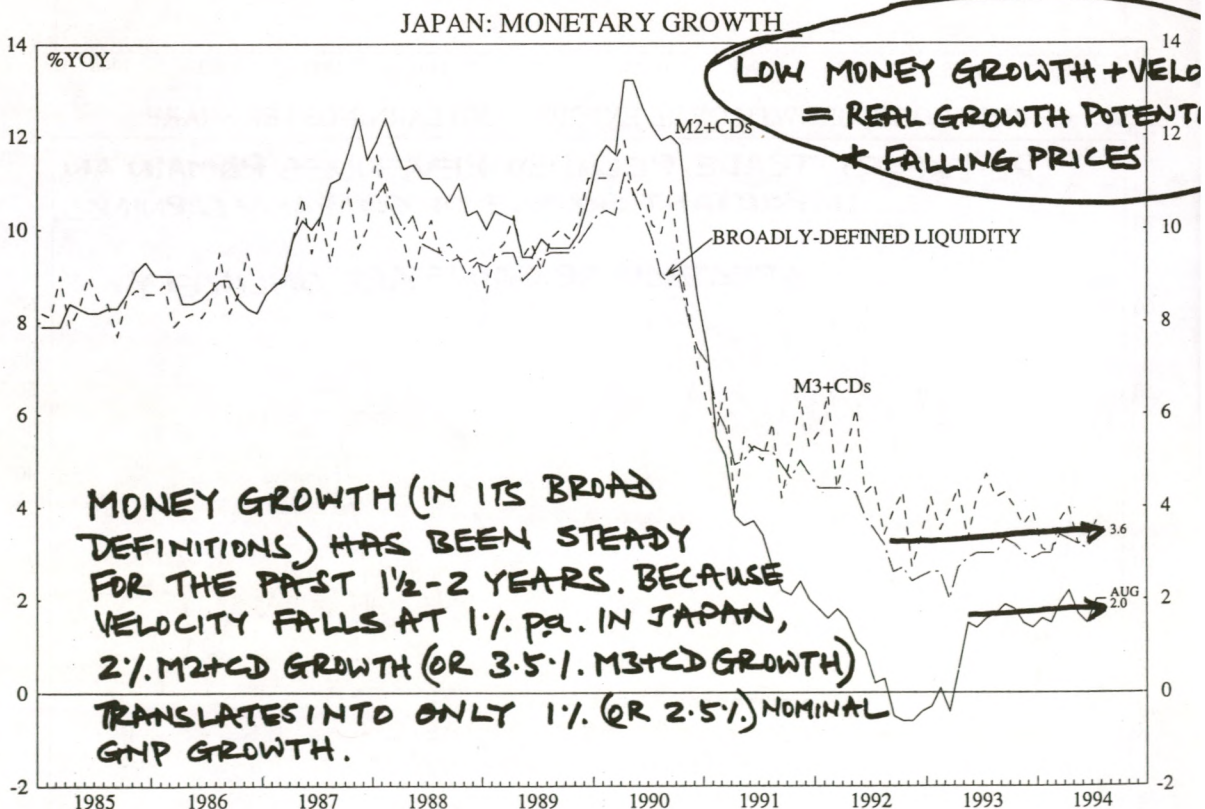


HONG KONG: GROWTH OF RE-EXPORTS AND EARNINGS PER SHARE

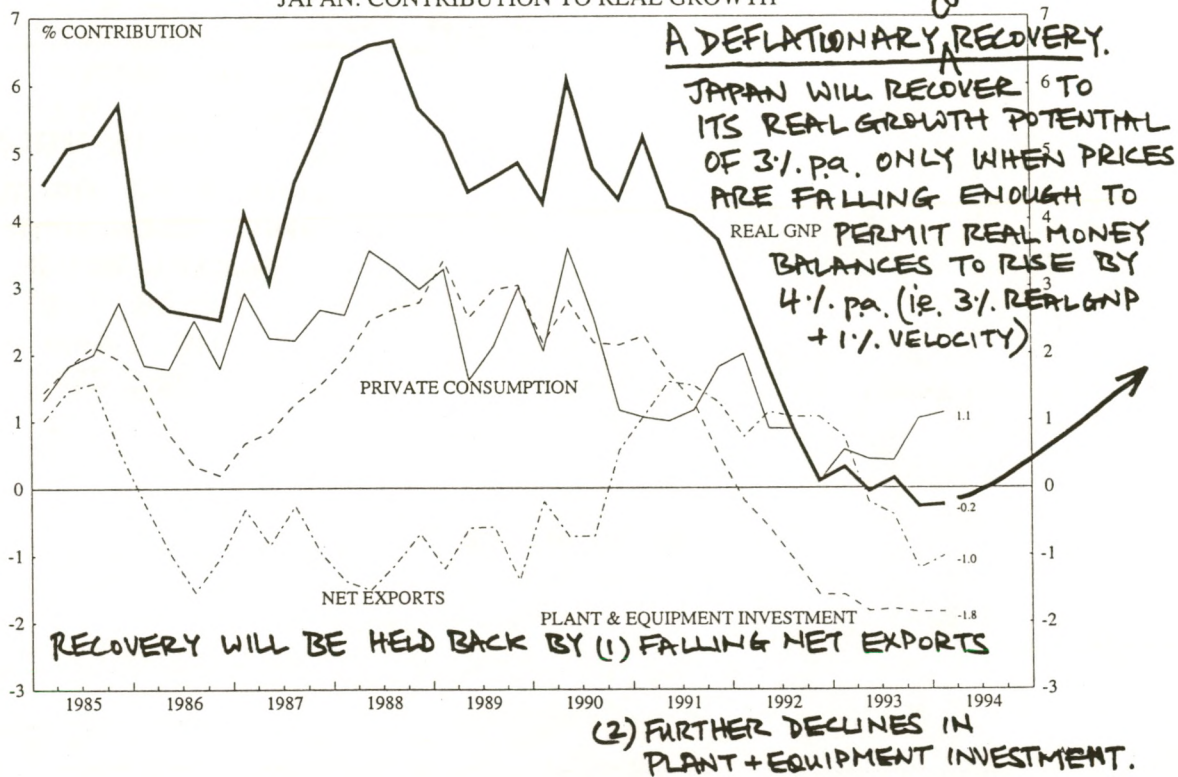


JAPAN A CONSUMER-LED, DEFLATIONARY RECOVERY

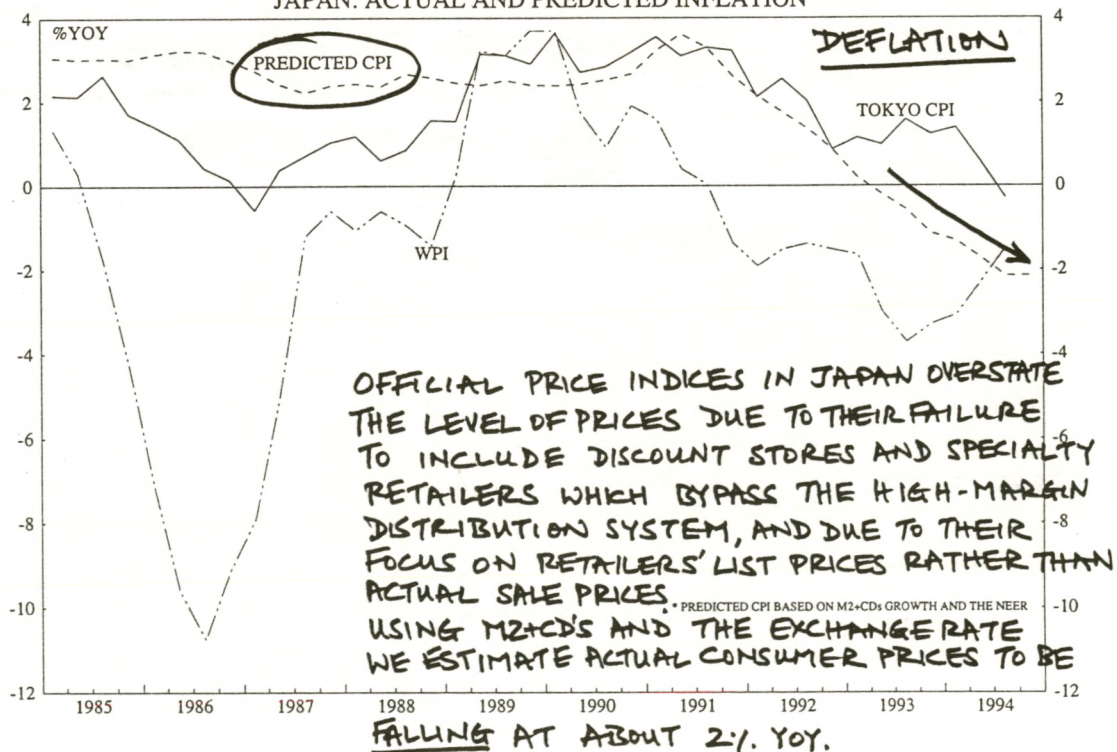
- * A deflationary recovery is under way in Japan. This is occurring because the combination of steady but very low money growth and falling prices is creating rising real purchasing power to drive the economy.
- * However, since the yen is above its purchasing power parity level (which we estimate at 110-120 per US\$), exports will be weak. Also, Japan has massive excess capacity at the current yen/dollar level. Hence as long as the yen remains strong, net exports and investment will contribute negatively to GDP, slowing the pace of recovery.
- * The main impetus for recovery will come from rising real wages as nominal wages stabilise and prices at retail stores fall. This will create a US or European-style, consumer-led recovery.
- * The Japanese balance of payments can be in equilibrium either with a large current account surplus plus equivalent net capital outflows, or a smaller current surplus plus smaller net capital outflows. However, in order for the trade and current surplus to narrow, imports must grow at roughly twice the rate of exports.



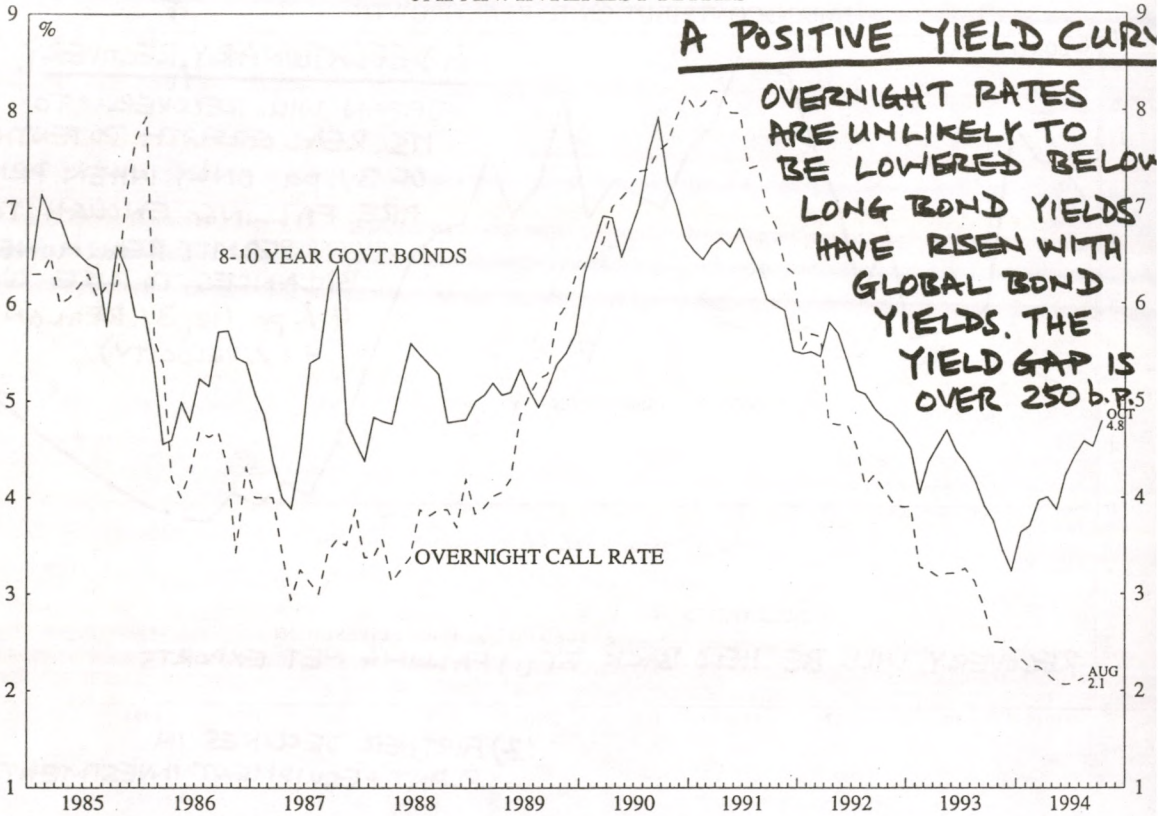
JAPAN: CONTRIBUTION TO REAL GROWTH



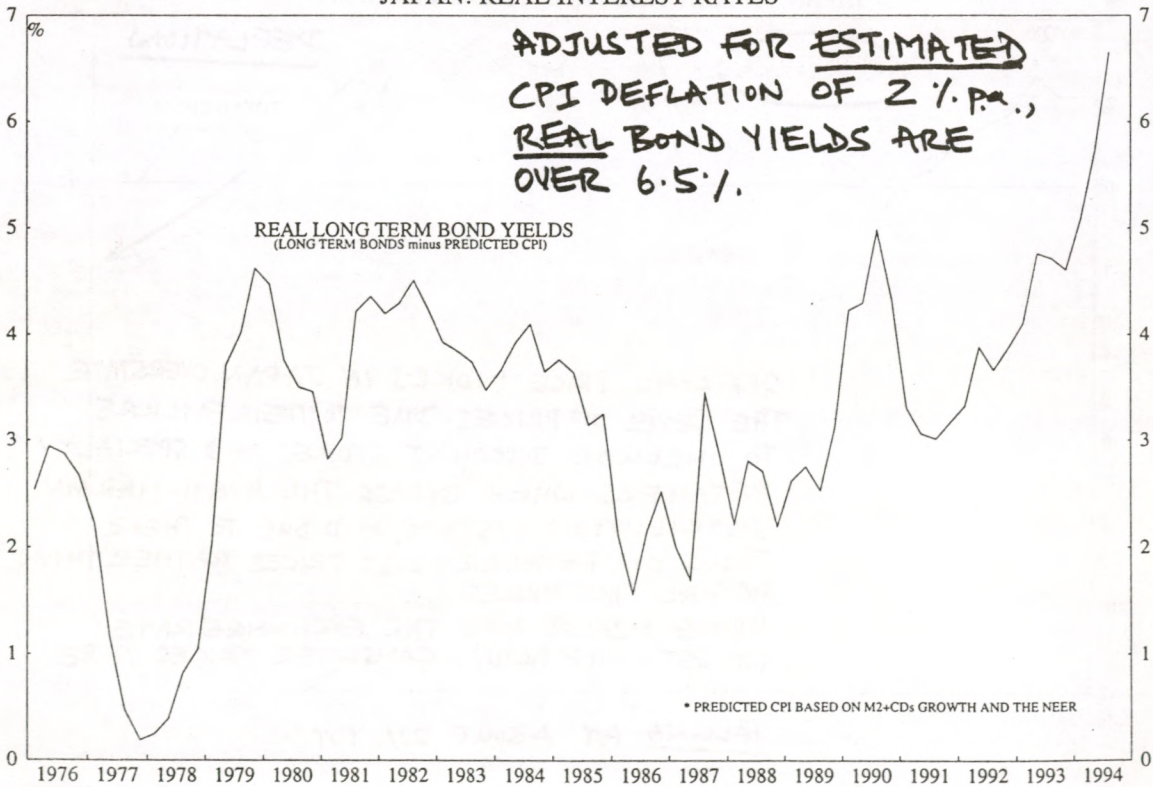
JAPAN: ACTUAL AND PREDICTED INFLATION



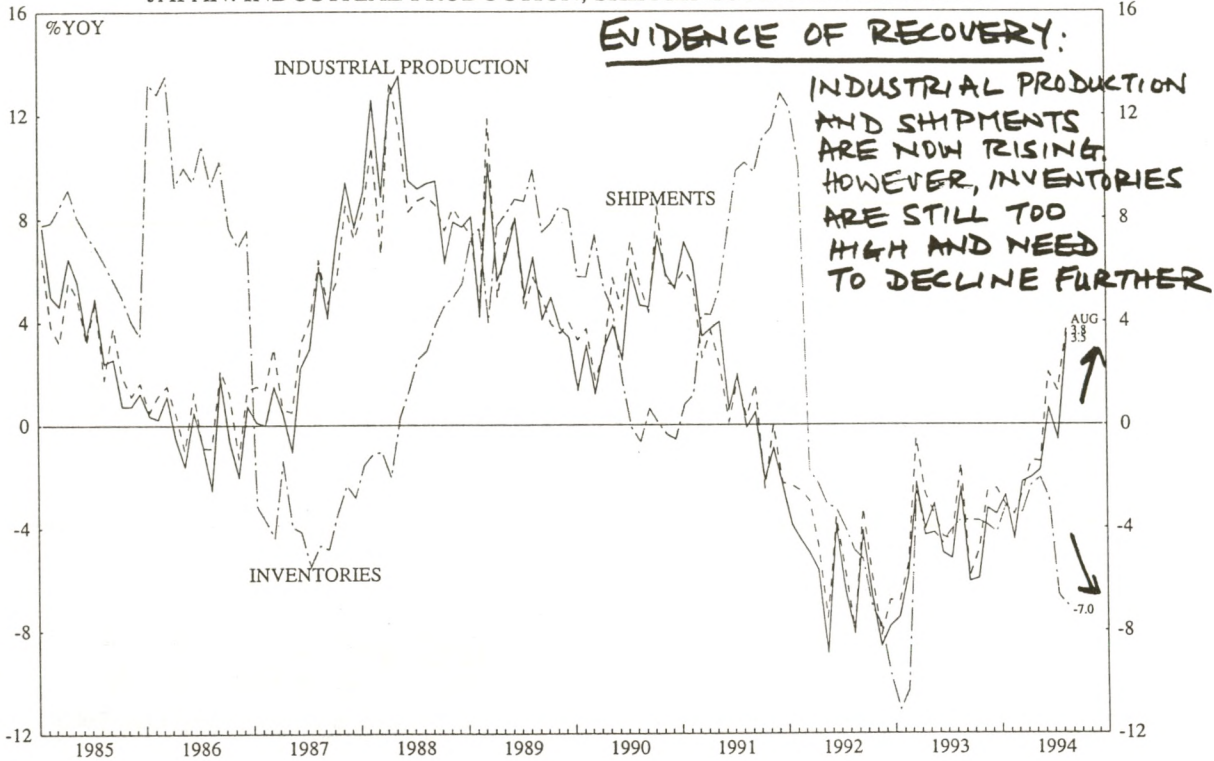
JAPAN: INTEREST RATES



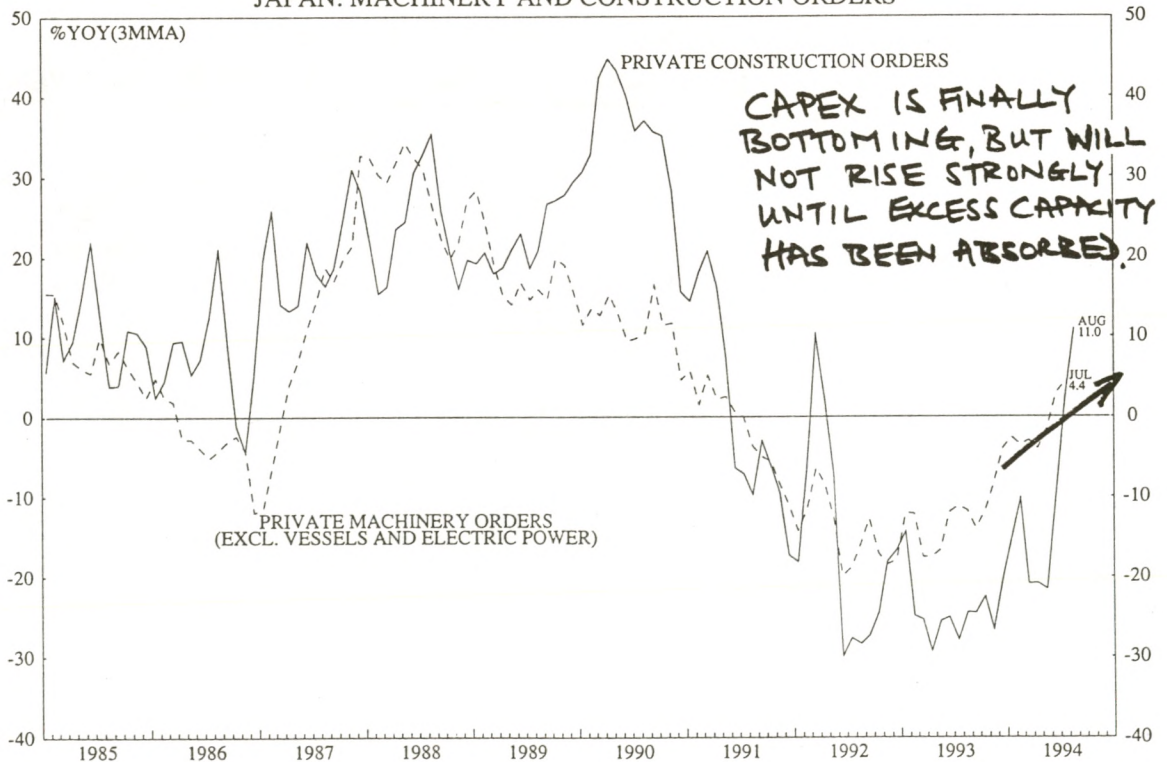
JAPAN: REAL INTEREST RATES



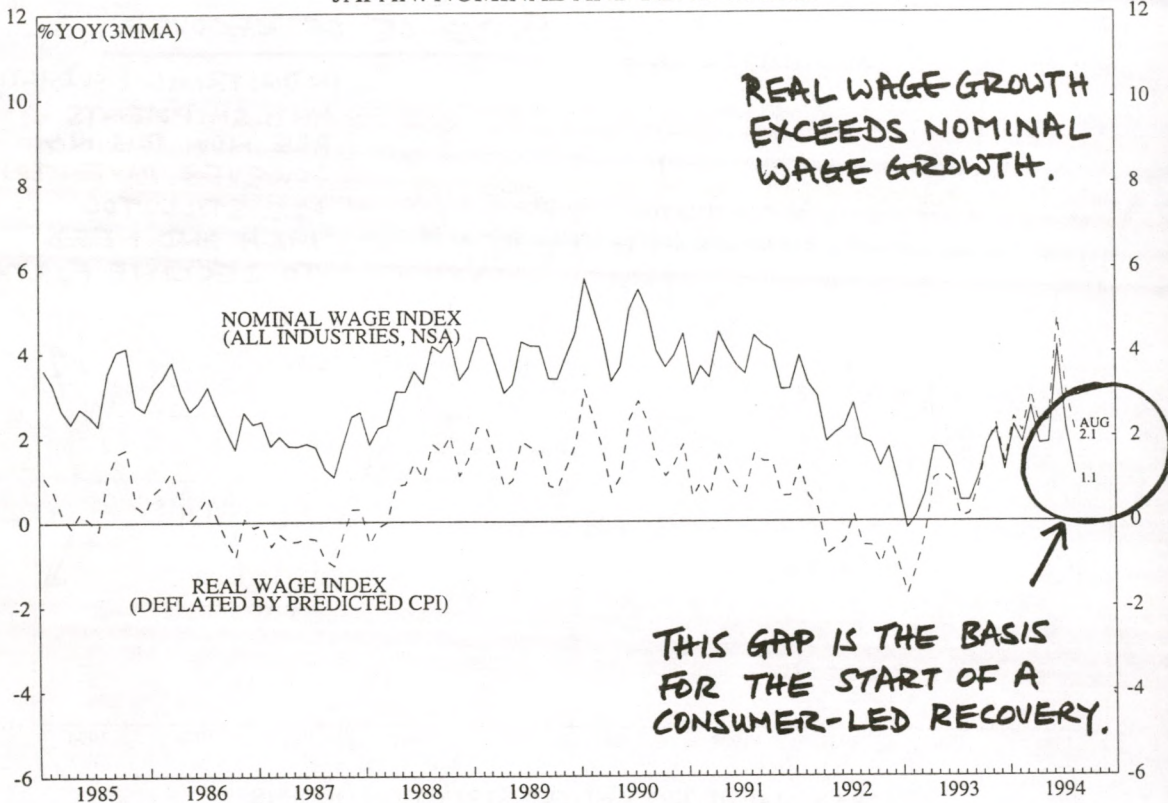
JAPAN: INDUSTRIAL PRODUCTION, SHIPMENTS AND INVENTORIES



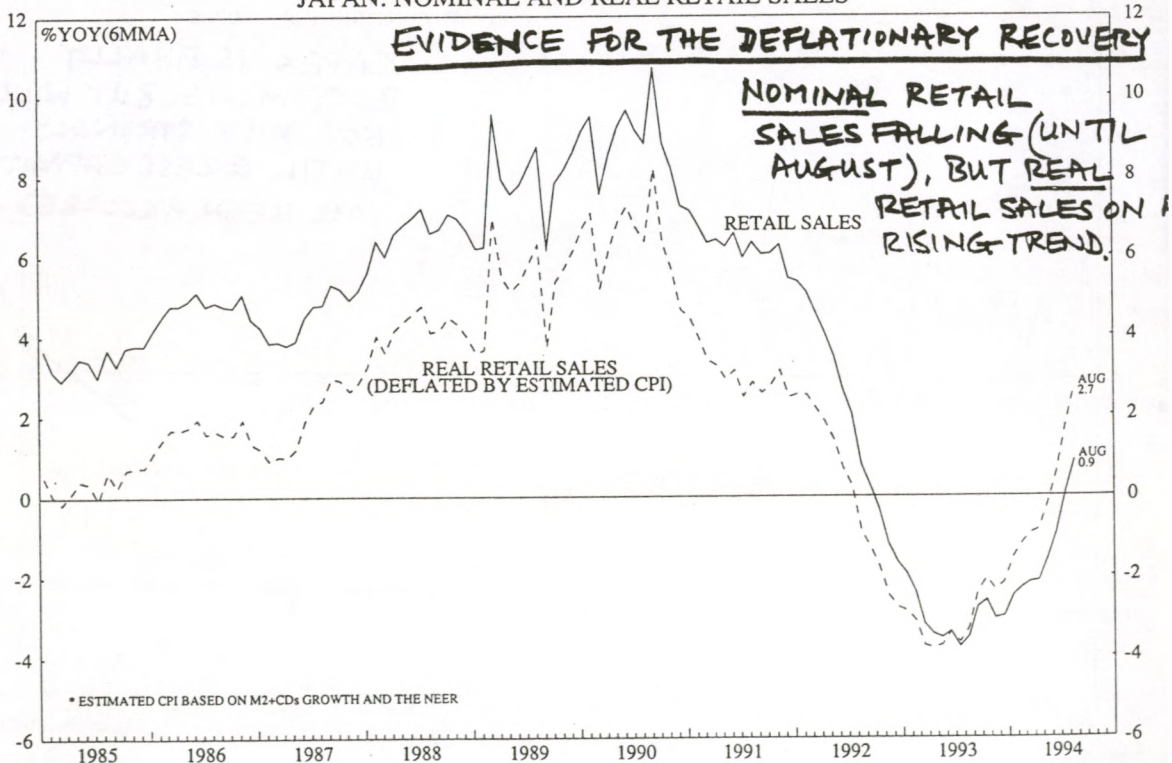
JAPAN: MACHINERY AND CONSTRUCTION ORDERS



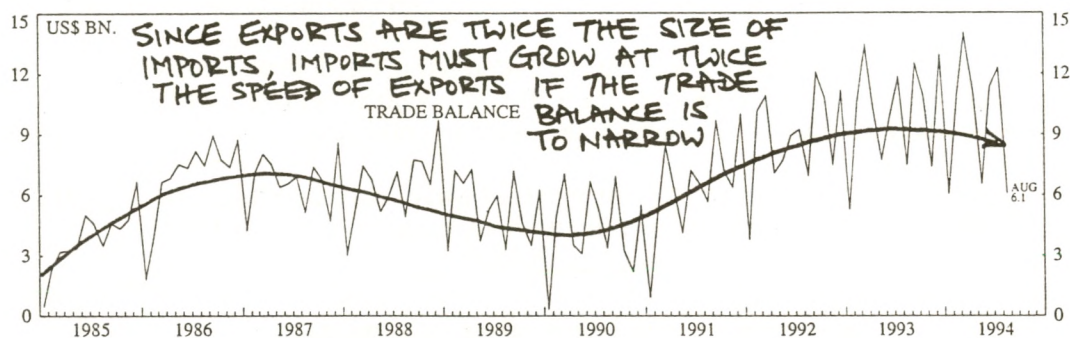
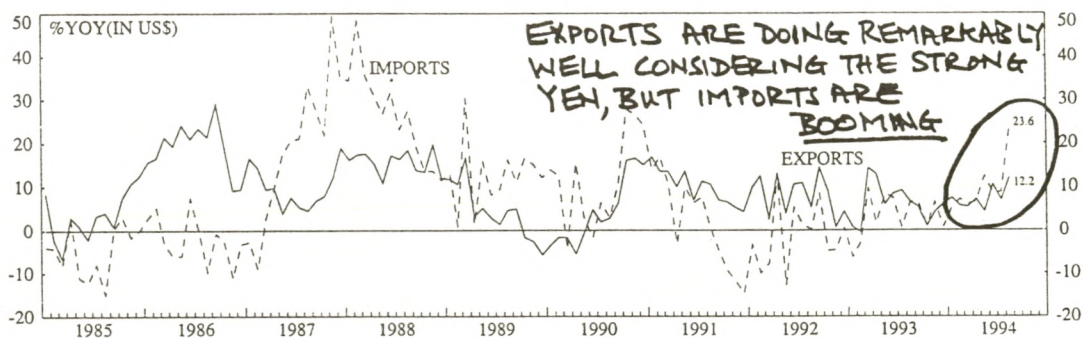
JAPAN: NOMINAL AND REAL WAGES



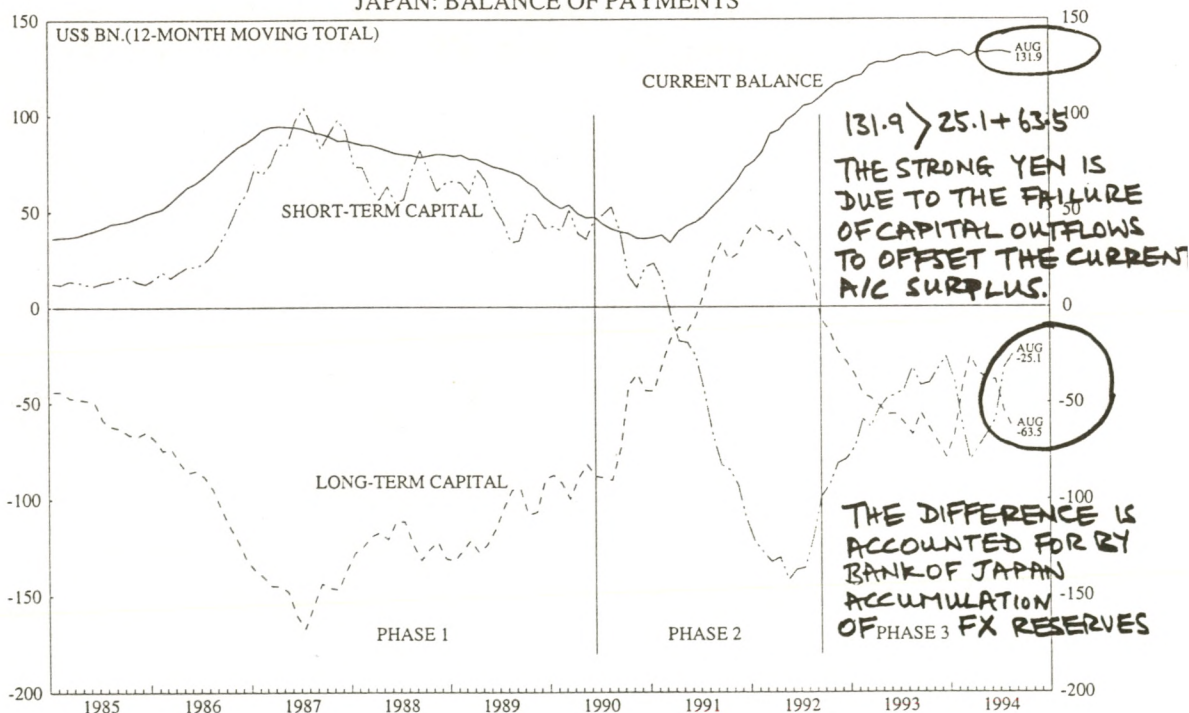
JAPAN: NOMINAL AND REAL RETAIL SALES



JAPAN: TRADE PERFORMANCE

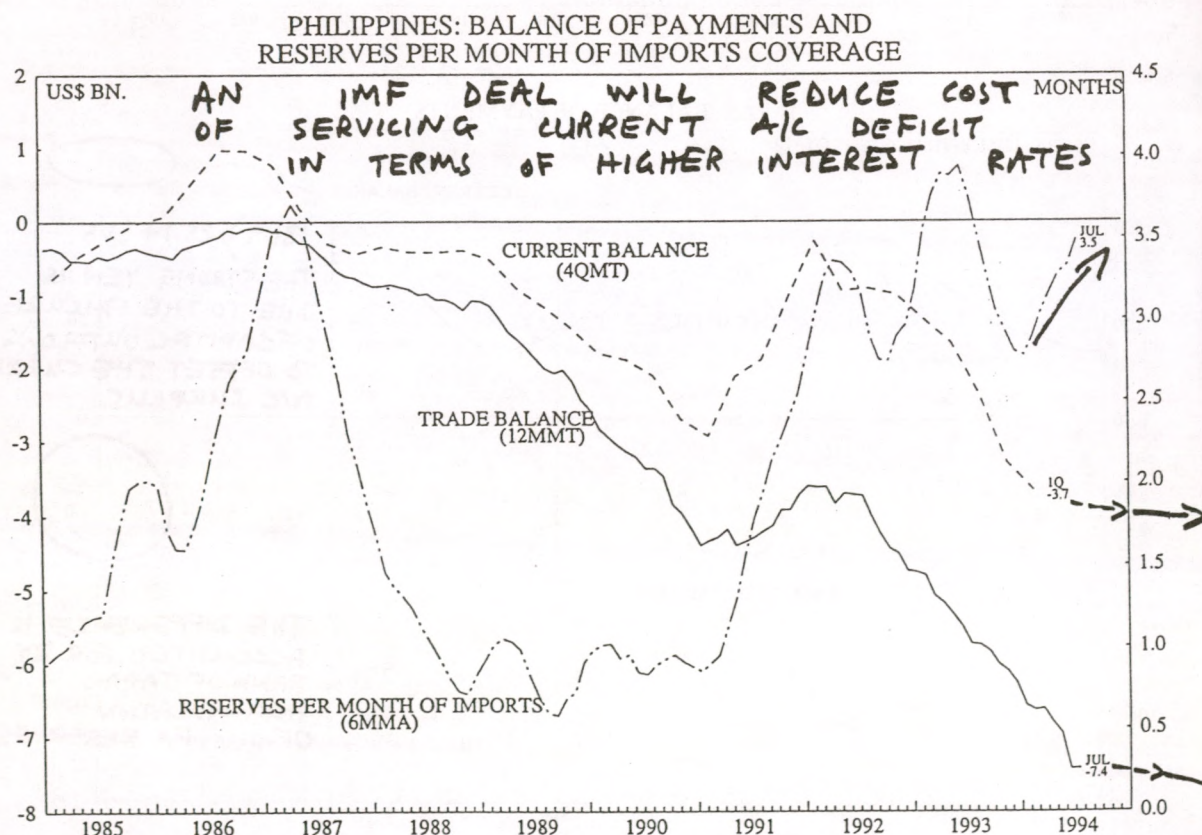


JAPAN: BALANCE OF PAYMENTS

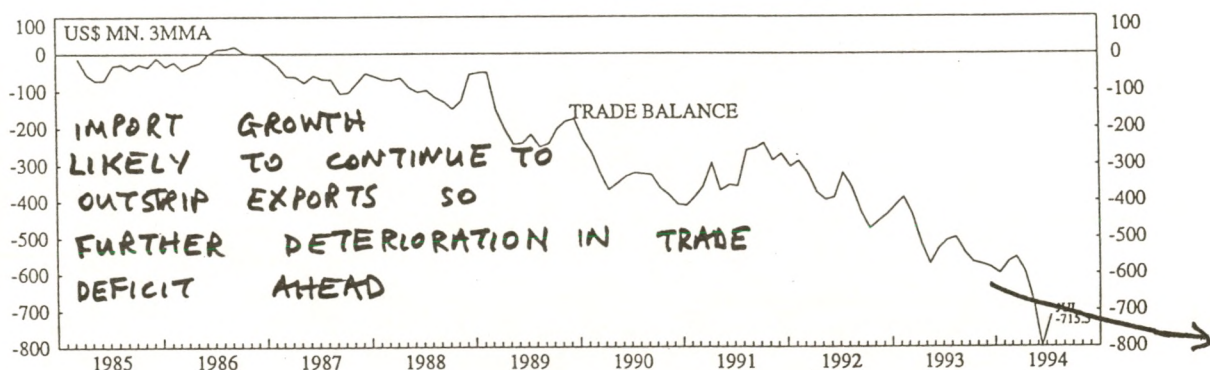
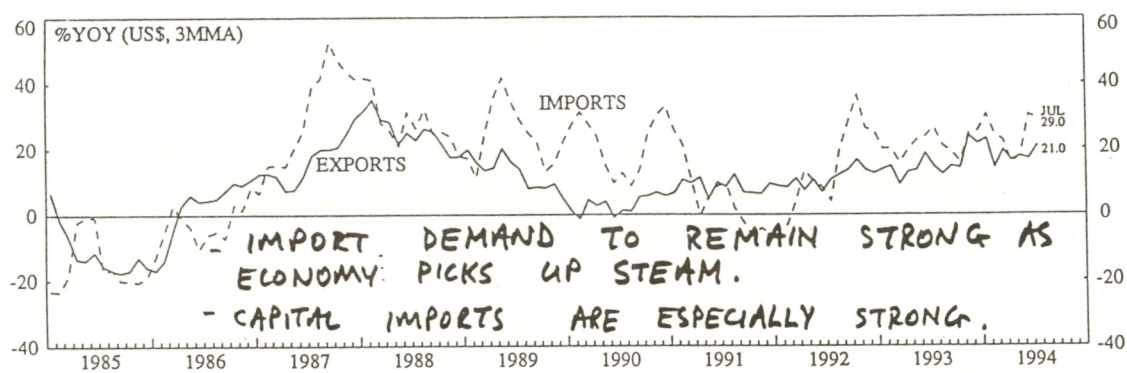


PHILIPPINES HIGHER INTEREST RATES AHEAD

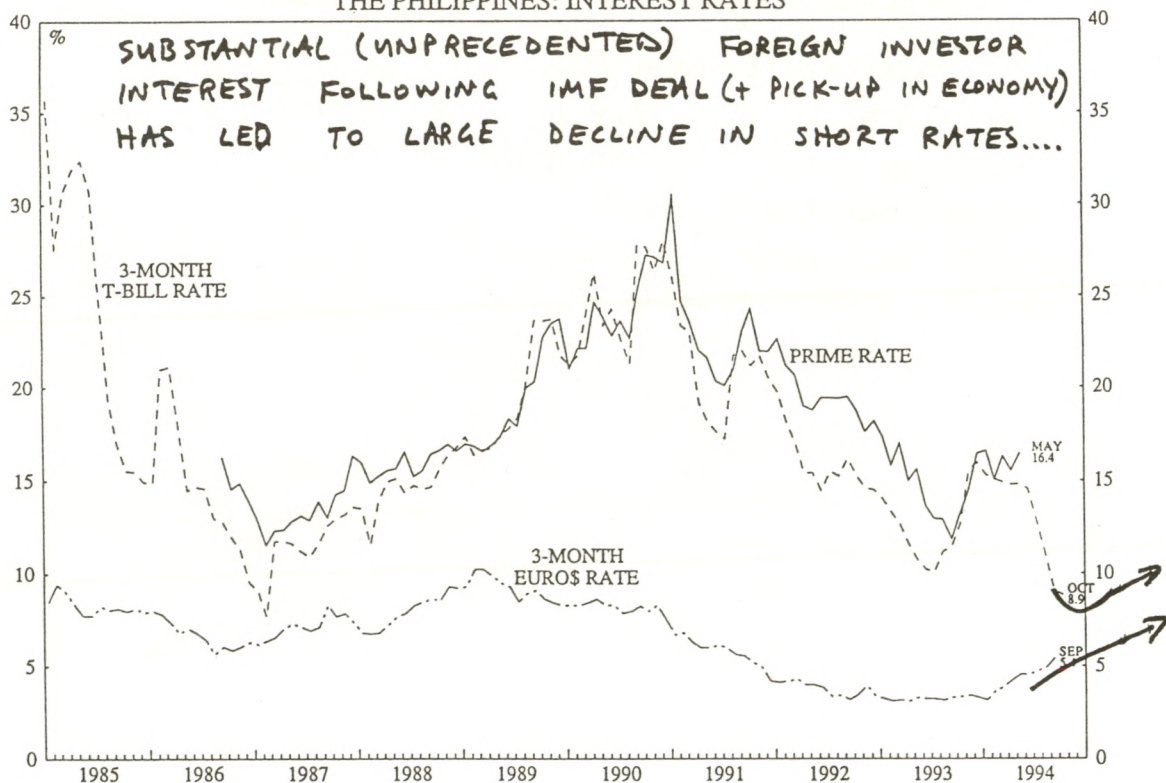
- * The Peso/US\$ has been strong as the country has been experiencing substantial short and long term capital inflows since the start of the year reflecting renewed foreign investor confidence. By conducting sterilised foreign exchange intervention the central bank has kept the monetary base on a stable trend (despite the relaxation in reserve ratios over the last 2 years which has worked against this policy).
- * The strong monetary and credit growth at present (partly generated by reduction in reserve requirements) will pave the way for a continuation in economic growth of around 3-4%. The momentum behind inflation is upwards and the central bank is unlikely to be successful in meeting IMF money and inflation targets this year.
- * The trade deficit will likely continue to widen while the deterioration of the current account deficit should slow over the following year (compared with the previous year) as the Philippines takes advantage of its recently acquired concessional loans.
- * Higher US rates and the ongoing trade deficit will enable the Philippines to maintain a greater degree of monetary restraint with a weaker currency in 1995.



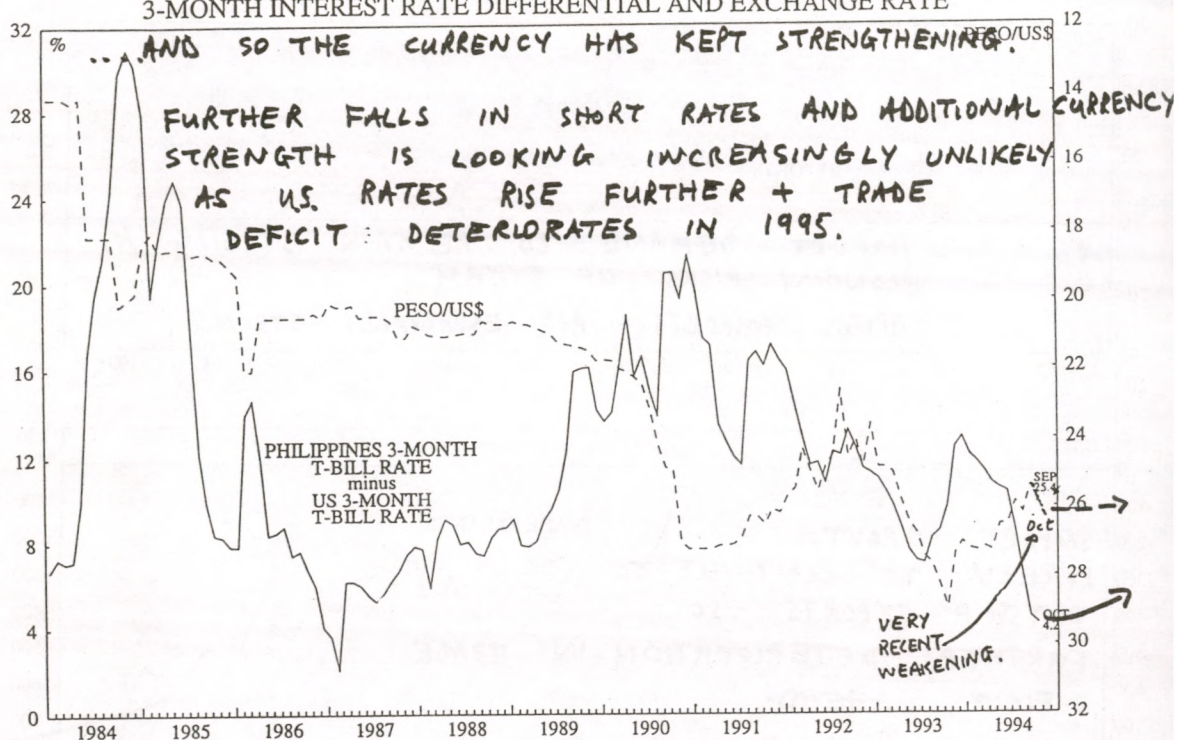
THE PHILIPPINES: TRADE PERFORMANCE



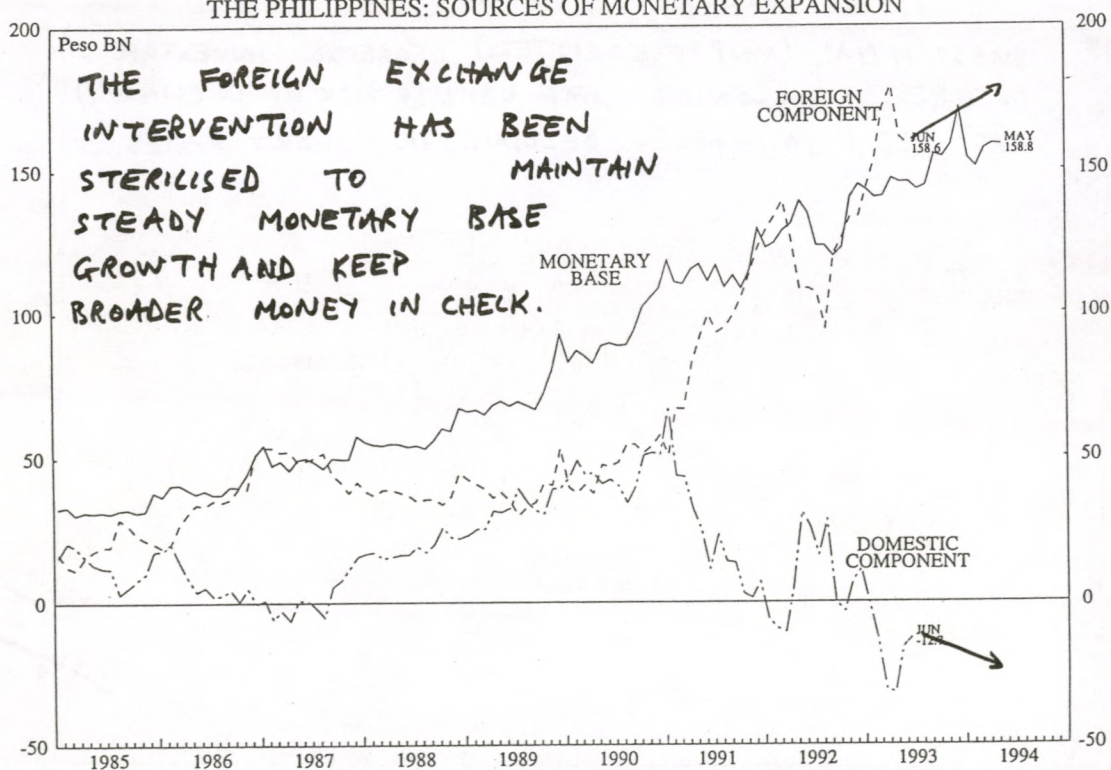
THE PHILIPPINES: INTEREST RATES



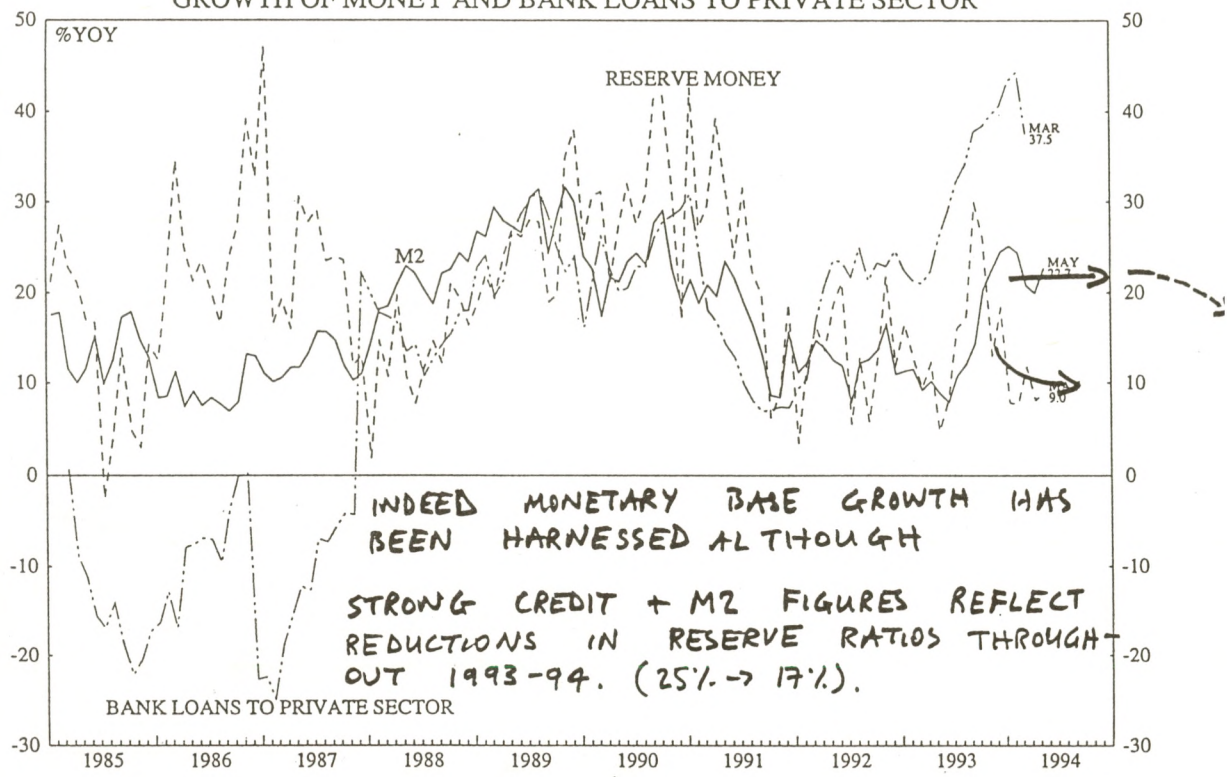
THE PHILIPPINES 3-MONTH INTEREST RATE DIFFERENTIAL AND EXCHANGE RATE



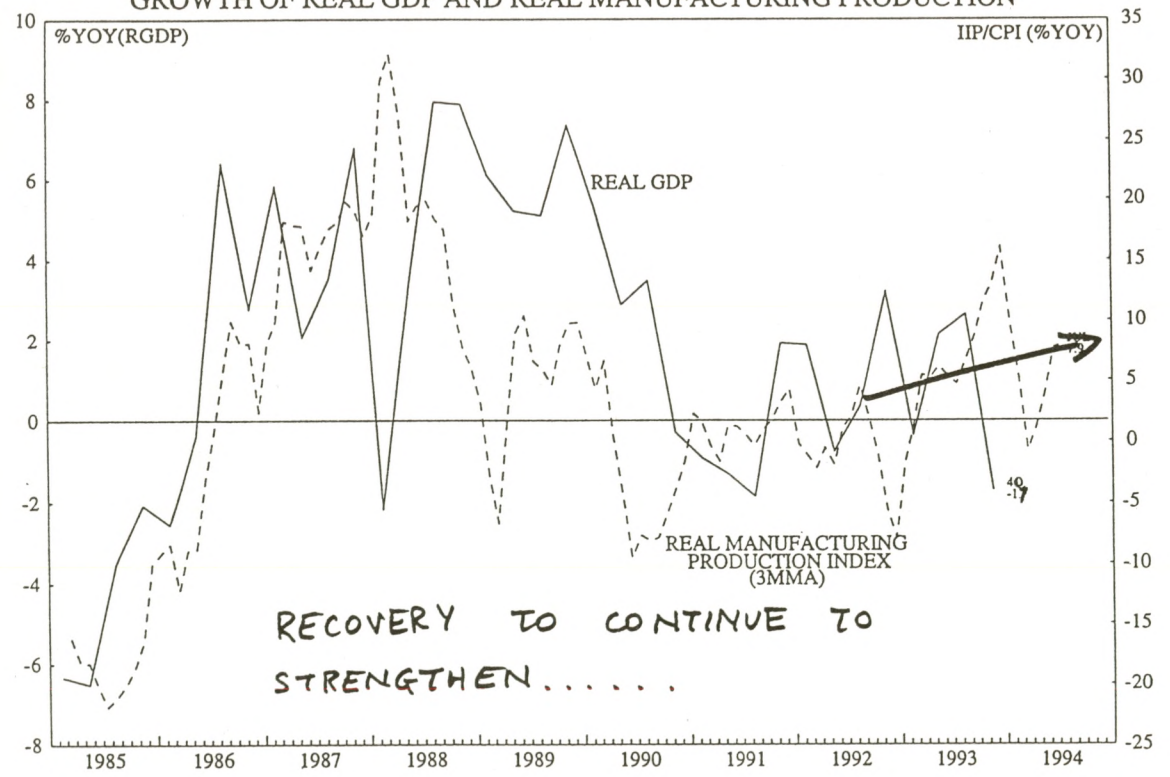
THE PHILIPPINES: SOURCES OF MONETARY EXPANSION



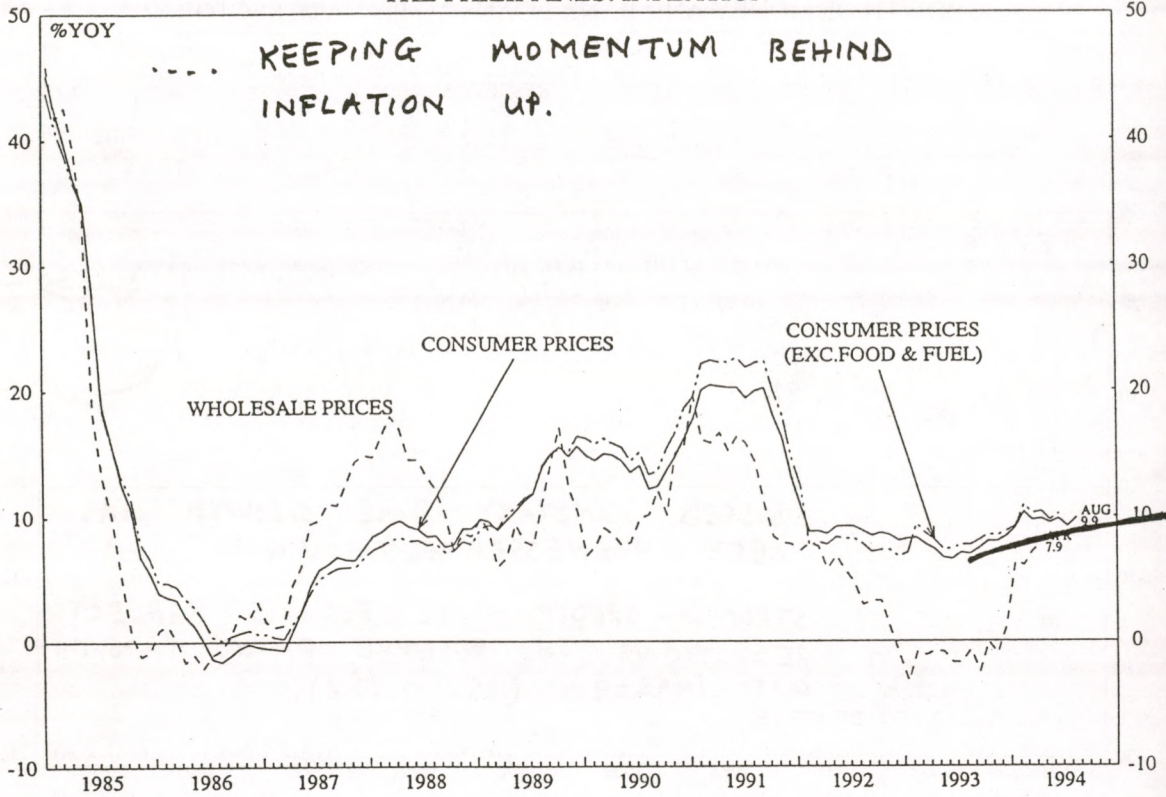
THE PHILIPPINES GROWTH OF MONEY AND BANK LOANS TO PRIVATE SECTOR



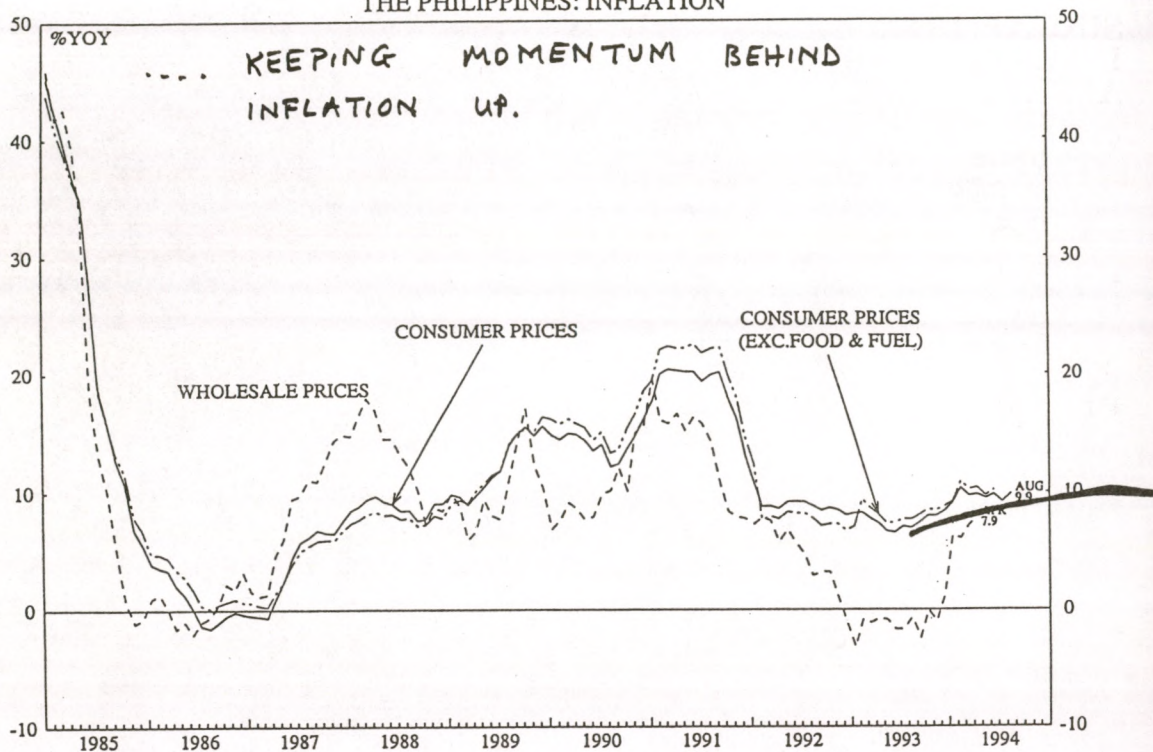
THE PHILIPPINES GROWTH OF REAL GDP AND REAL MANUFACTURING PRODUCTION



THE PHILIPPINES: INFLATION

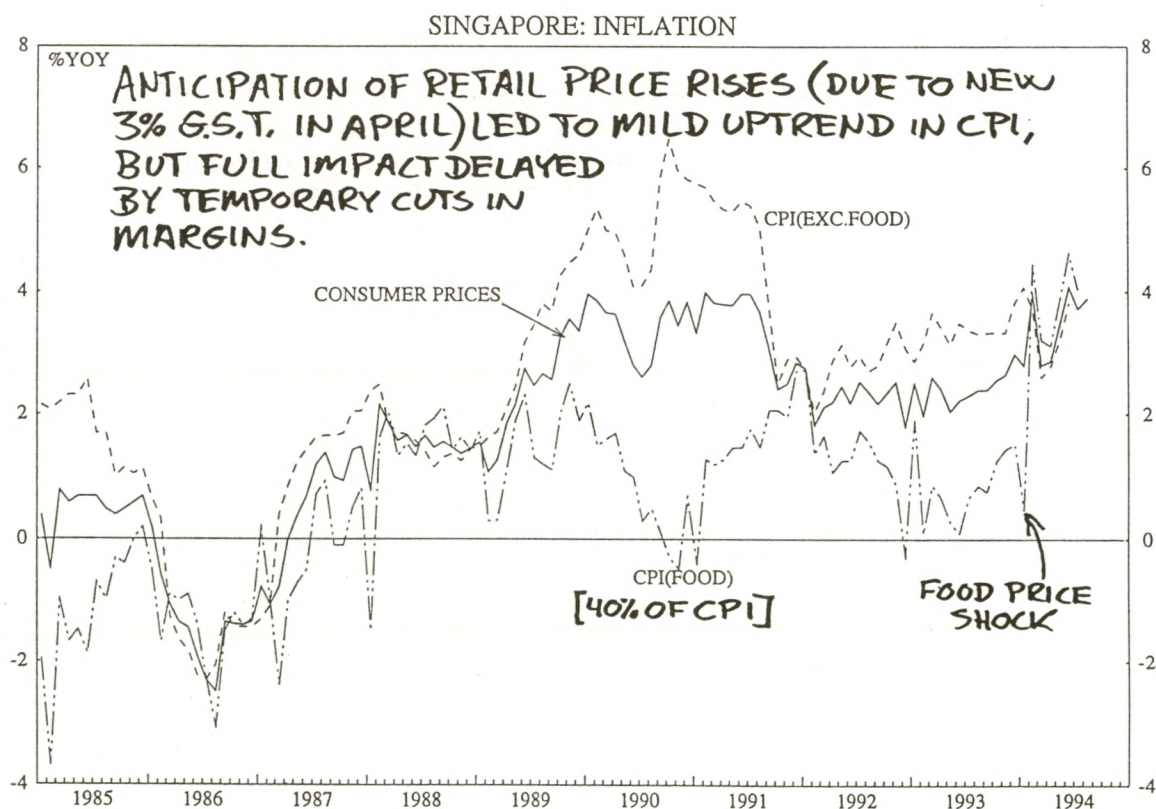


THE PHILIPPINES: INFLATION

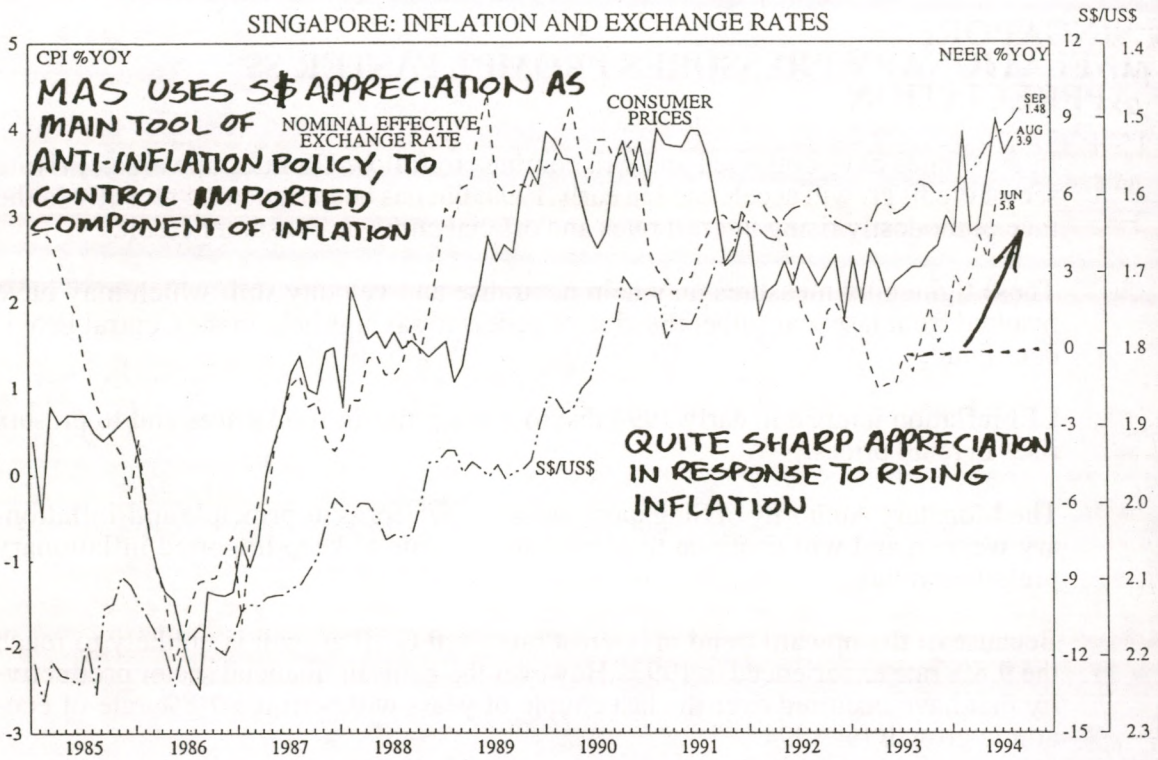


SINGAPORE INFLATIONARY PRESSURES PROMPT FASTER S\$ APPRECIATION

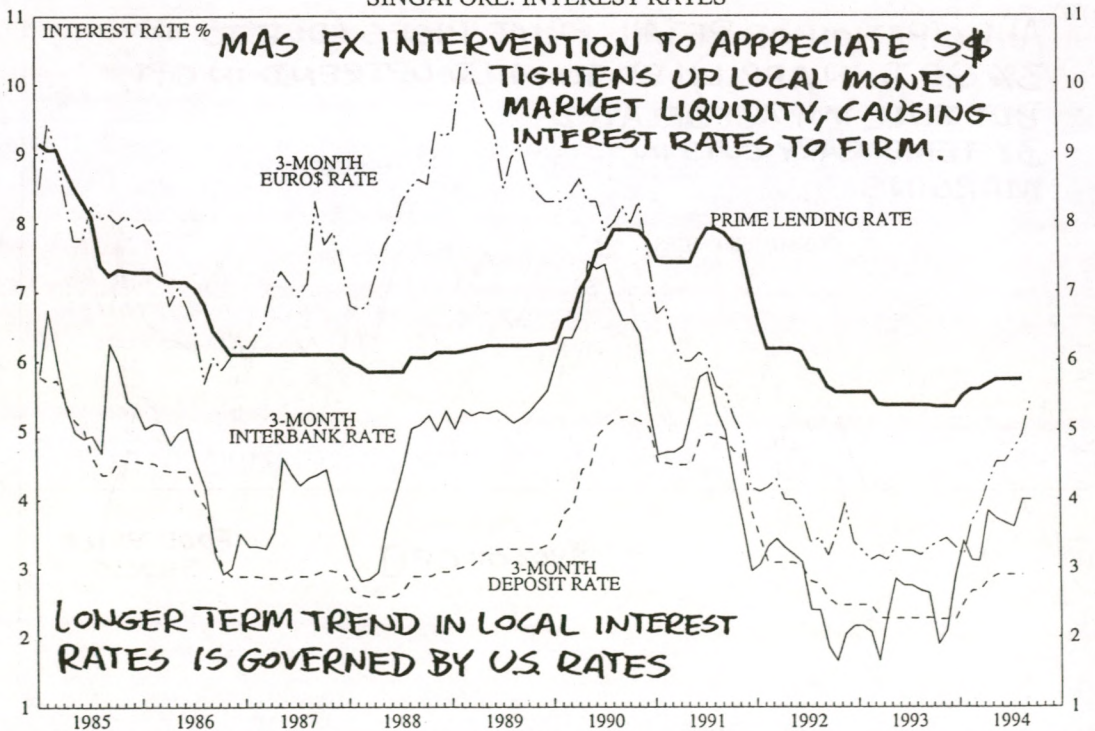
- * Interest rates have bottomed and will continue to follow US rates upwards. Private sector credit growth accelerated in early 1994, but has been flattening recently in the face of modestly rising interest rates and official curbs on consumer credit.
- * These tightening measures may help neutralise and velocity shift which may have resulted from last year's liberalisation of access to savings held in the Central Provident Fund.
- * CPI inflation jumped in early 1994 due to a sharp rise in food prices and to pre-tax rises in retail prices.
- * The Monetary Authority of Singapore uses the S\$/US\$ as its principle anti-inflationary weapon and will continue to appreciate this rate to keep imported inflationary pressures at bay.
- * Because of the upward trend in interest rates real GDP growth is unlikely to reach the 9.8% rate experienced in 1993. However the gains in financial sector productivity that have occurred over the last couple of years will permit a 7-8% rate of economic growth for 1994.



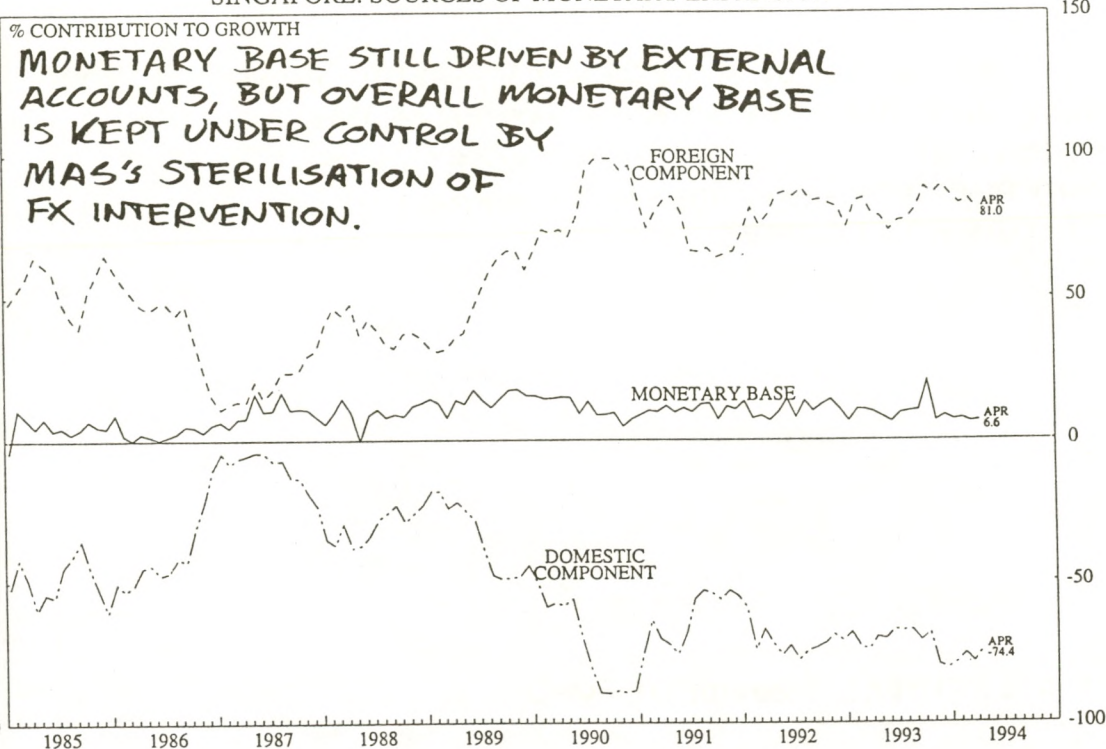
SINGAPORE: INFLATION AND EXCHANGE RATES



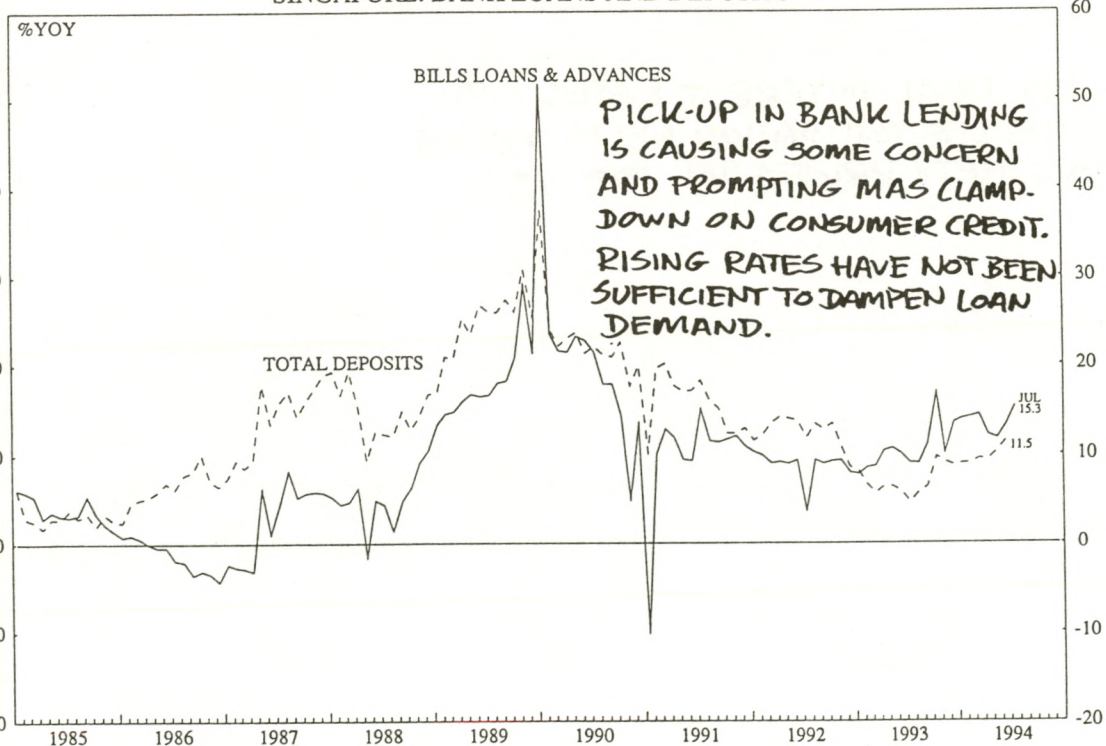
SINGAPORE: INTEREST RATES



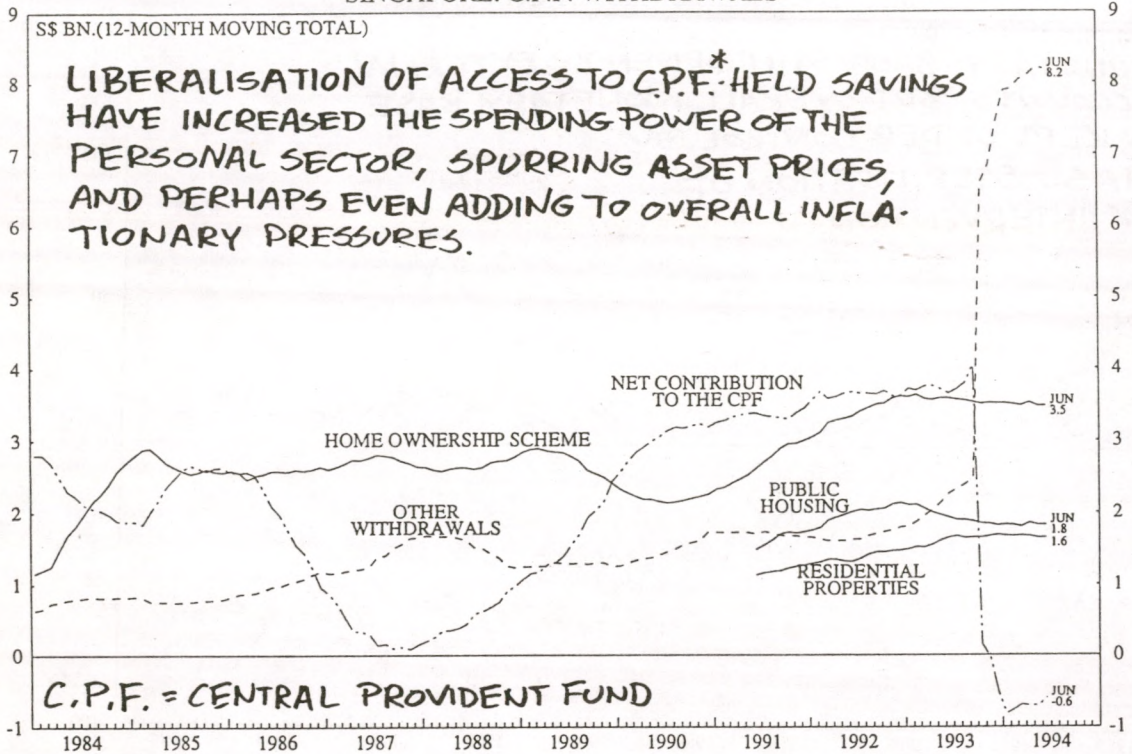
SINGAPORE: SOURCES OF MONETARY EXPANSION



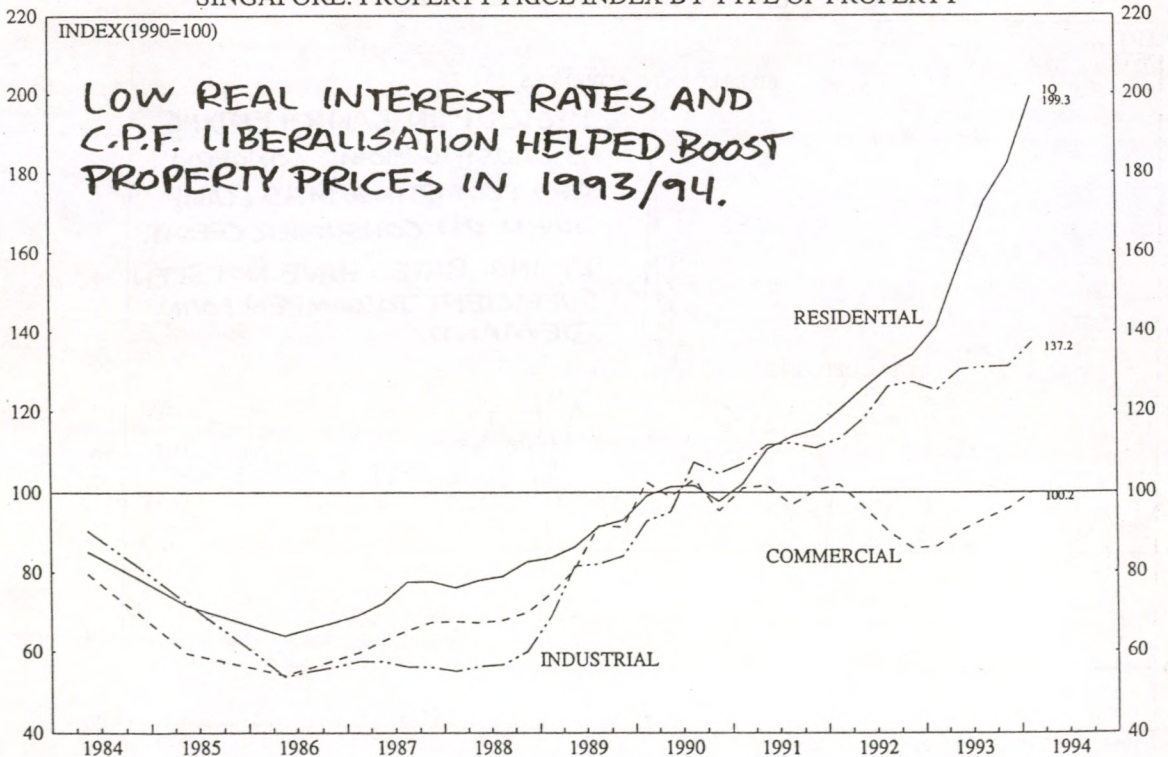
SINGAPORE: BANK LOANS AND DEPOSITS



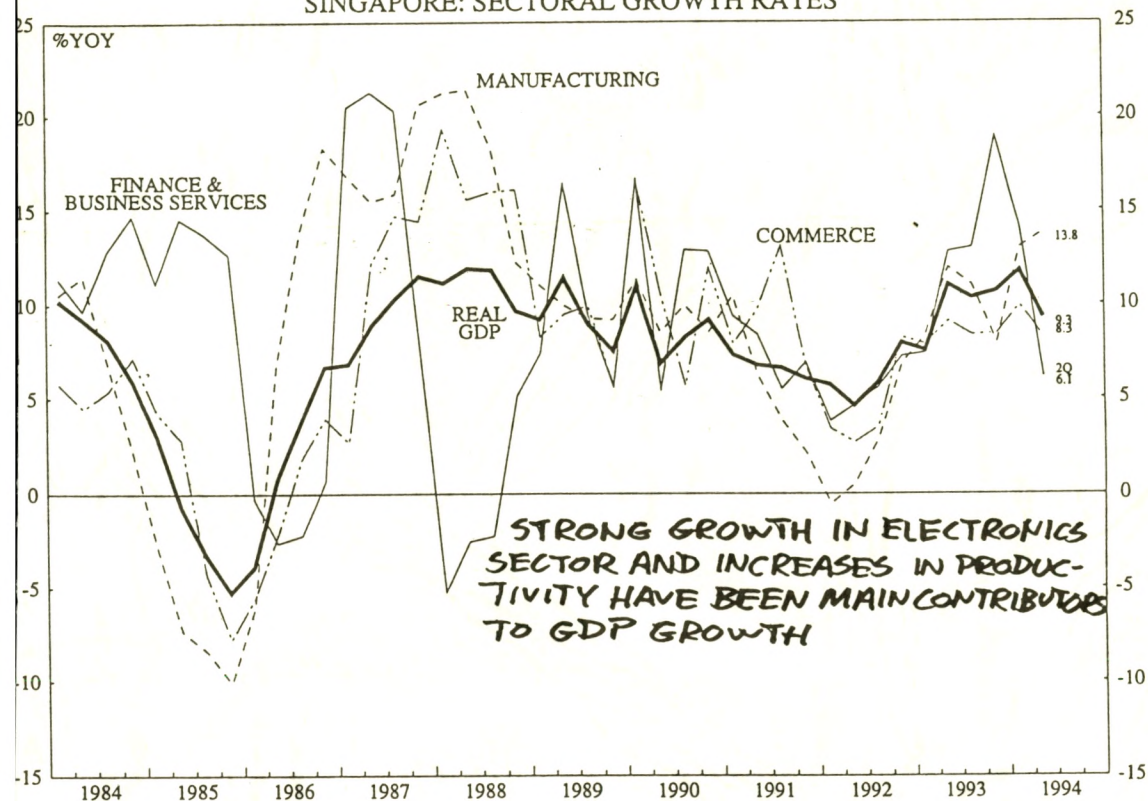
SINGAPORE: C.P.F. WITHDRAWALS



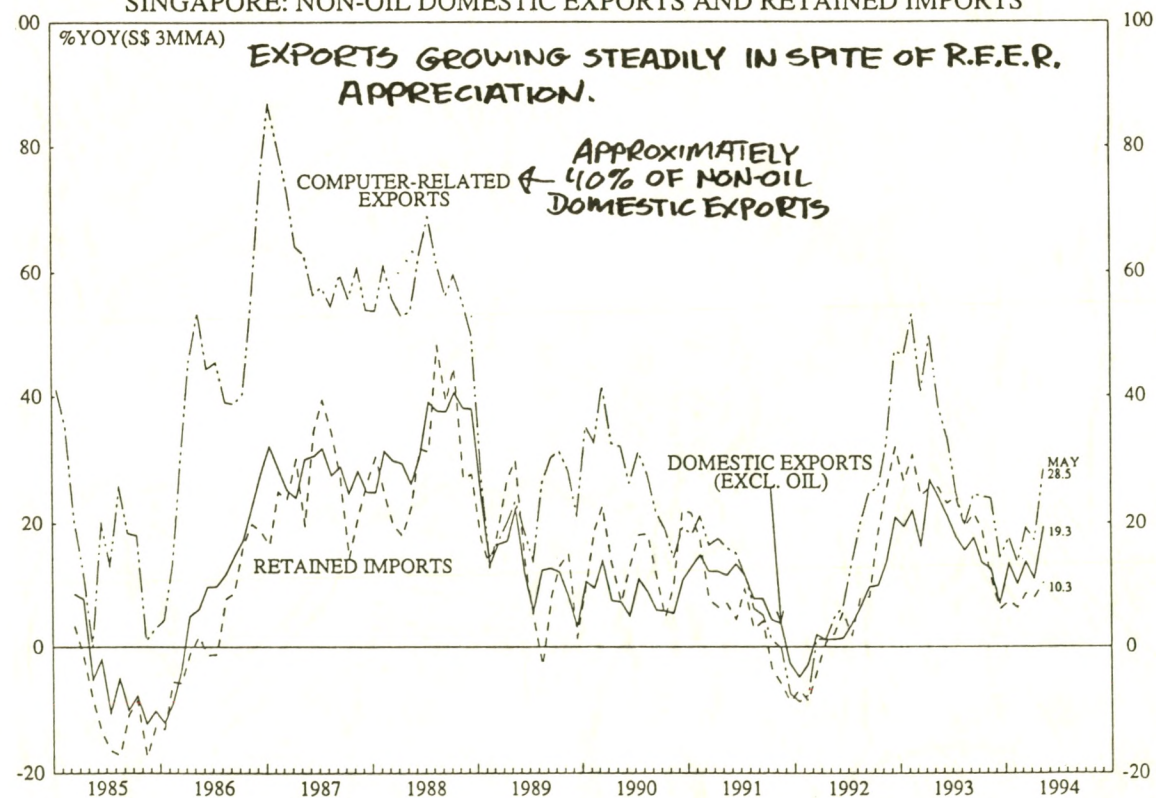
SINGAPORE: PROPERTY PRICE INDEX BY TYPE OF PROPERTY



SINGAPORE: SECTORAL GROWTH RATES

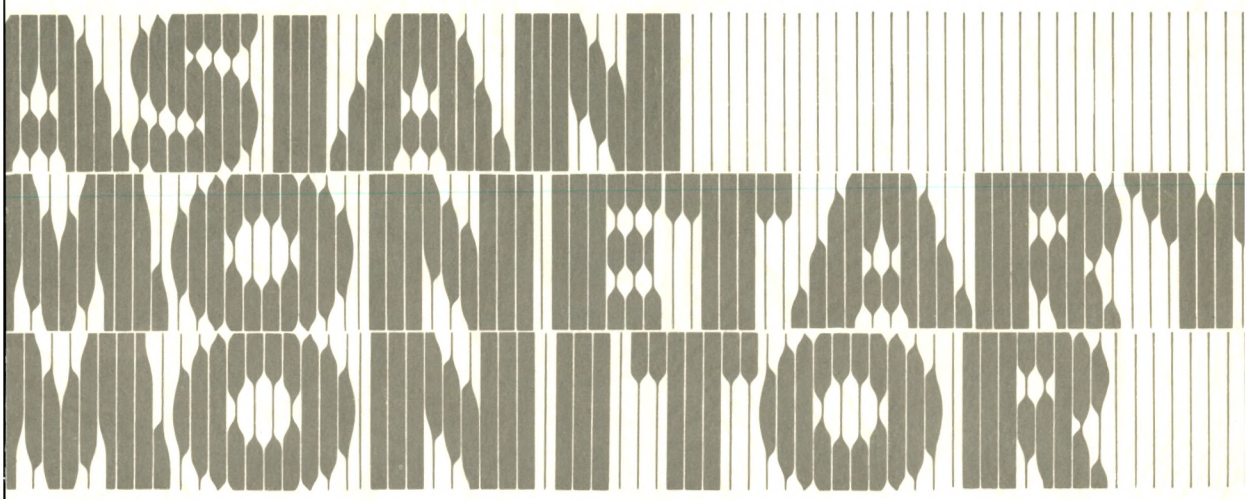


SINGAPORE: NON-OIL DOMESTIC EXPORTS AND RETAINED IMPORTS



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CONTENTS

	Page
MALAYSIA	
A Positive 1995 Budget with a Negative Outlook for Liquidity by Philip Wyatt	1
PAKISTAN	
External Fragility Remains, but Further Fiscal Reform in Store by Philip Wyatt	9
THAILAND	
Tackling Capital Inflows with Bank Supervision by Jakob Lund	22





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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price US\$300 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to the Editor, Asian Monetary Monitor Ltd., GPO Box 12964, Hong Kong.

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ASIAN MONETARY MONITOR

November-December 1994

Vol. 18 No.6

MALAYSIA A POSITIVE 1995 BUDGET WITH A NEGATIVE OUTLOOK FOR LIQUIDITY

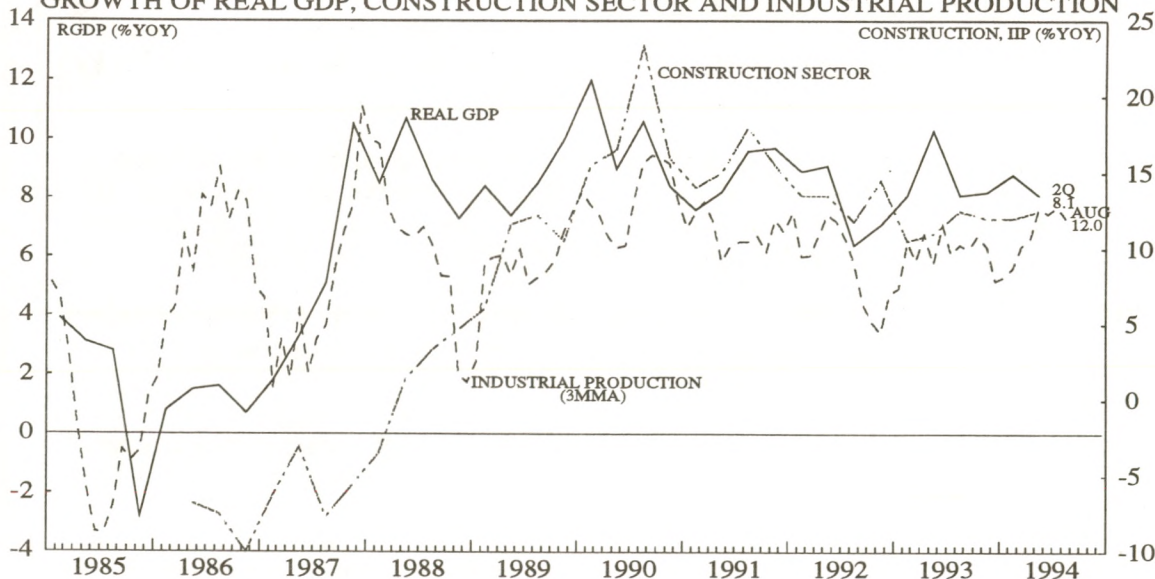
This article assesses the likely impact of what at first sight appears to be a broadly stimulative budget for the economy. The budgetary changes for the next fiscal year have been made at a time when most measures of economic activity show it to be barrelling along at a vigorous pace (with the economy possibly operating near to full capacity, see AMM Vol. 18 No. 4) (Chart 1). National Government elections are to be held sometime (probably early) in 1995 so a healthy economic background is desirable from a political perspective. However, 1995 will be a much more difficult year for liquidity conditions in Malaysia than 1994 and it is likely that by the end of 1995 a substantial tightening up in credit conditions with higher local interest rates will have brought about the initial signs of a slowing in the real economy. Consequently this budget and the current state of the economy are potentially misleading indicators for stockmarket and economic conditions in 1995.

The 1995 Budget

In the treasury's economic report the picture painted for 1995 is a rosy one. Real GDP growth is to remain robust at 8.5%, with an inflation rate at (or below) 3.8% in 1995 (with an estimated 3.8% for 1994). The impact of the budgetary measures is officially

MALAYSIA: CHART 1

GROWTH OF REAL GDP, CONSTRUCTION SECTOR AND INDUSTRIAL PRODUCTION



Box 1

MAJOR CHANGES IN THE 1995 BUDGET

TAXATION

- * Personal income taxes were reduced by 2-3% across all income brackets.
- * Corporate income tax reduced by 2% to 32% for FY93 earnings and to 30% for FY94 earnings.
- * Import duties on more than 500 products, which previously carried 2-5% levies, are to be abolished. Imports of: household items, raw materials and components, textile products and aluminium ore will be affected.
- * Sales tax of 10% abolished on 44 machine components.
- * Investment income of life insurance companies to be taxed at 8% instead of at existing corporate tax rate.

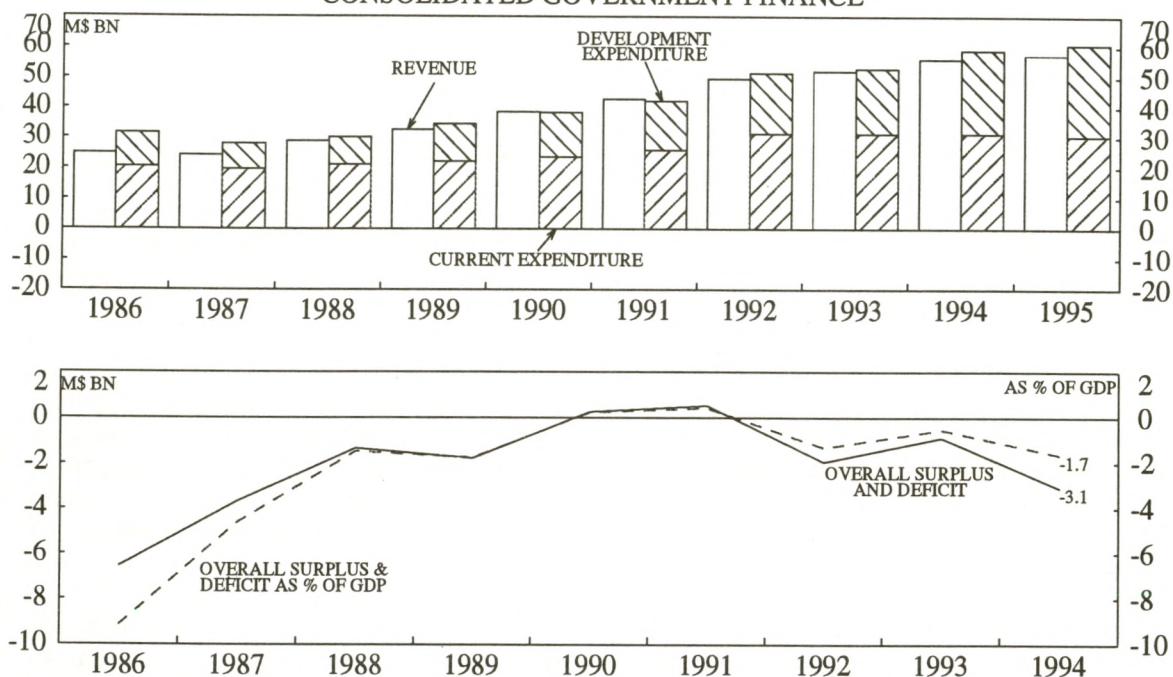
EXPENDITURE

- * Allocation of RM2.07 bn over 1995 for the construction of roads, and road improvements and RM1.84 bn for the upgrading and construction of schools. Around RM400 m to be spent on railway projects.
- * Allocation of funds for low-cost housing programme increased by RM/bn to RM2.6 bn.

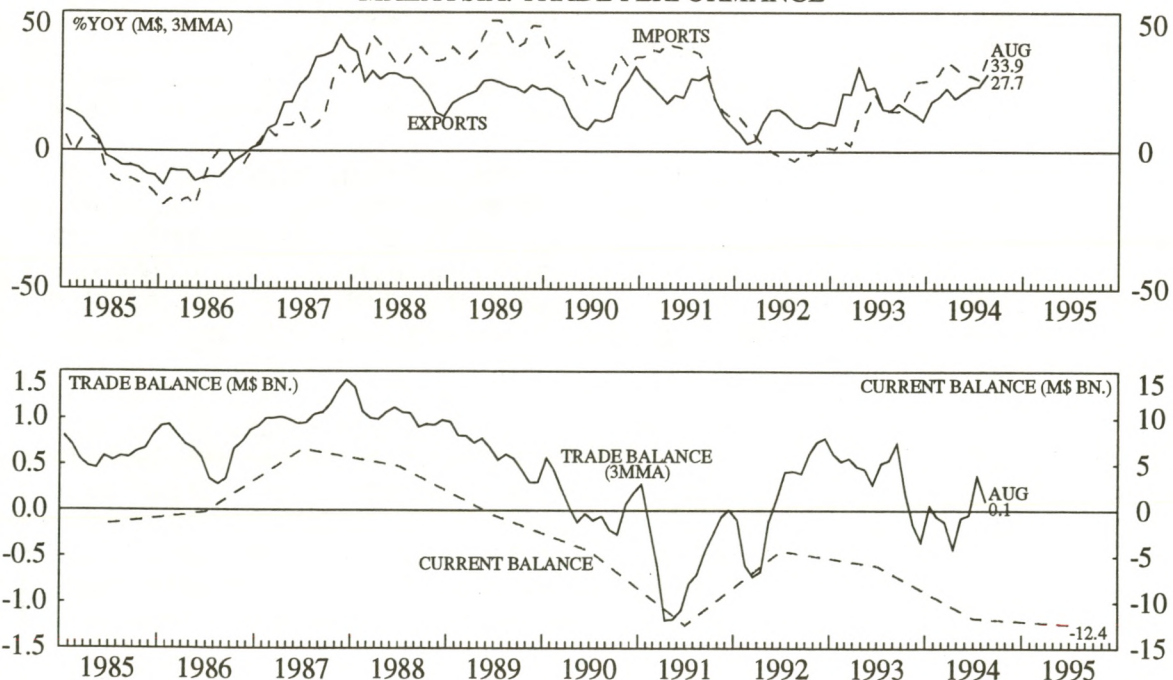
OTHER MEASURES AND INCENTIVES

- * Non-residents can obtain housing loans of any amount from domestic banks subject to certain conditions.
- * An EPF contributor can withdraw 30% of their balance as a lump sum to facilitate the purchase of a house. This replaces the old rules where the withdrawal limit was 20% of their total contributions provided the maximum amount withdrawn did not exceed RM40,000.
- * Exporters can retain part of foreign currency proceeds in Malaysian foreign currency accounts. Overseas residents and students may open foreign currency accounts both locally and abroad.
- * An increase in tax exemption from 50% to 70% of income from overseas investments remitted back to Malaysia.

MALAYSIA: CHART 2
CONSOLIDATED GOVERNMENT FINANCE



MALAYSIA: CHART 3
MALAYSIA: TRADE PERFORMANCE



expected to result in a mild expansion in the overall public sector deficit from RM3.1 bn in 1994 to RM3.5 bn (or 1.8% of GNP) in 1995. On the external side a current account deterioration from RM11.7 bn in 1994 to RM12.4 bn (or 6.4% of GNP) in 1995 is officially expected (Charts 2 and 3).

As can be seen from Box 1, a large number of the tax changes to be made in 1995 involve a reduction in import tariffs. These are positive moves in the area of trade liberalisation. However, the existence of price controls on a range of locally sold commodities makes the overall pricing structure rigid. Given the presence of inflationary pressures in the economy, partly held back by (sluggish) price controls, the recent cutbacks in tariffs will temporarily take the downward pressure off profit margins of the producers of goods with a significant imported content. The prospective acceleration of CPI inflation next year could be delayed as a result.

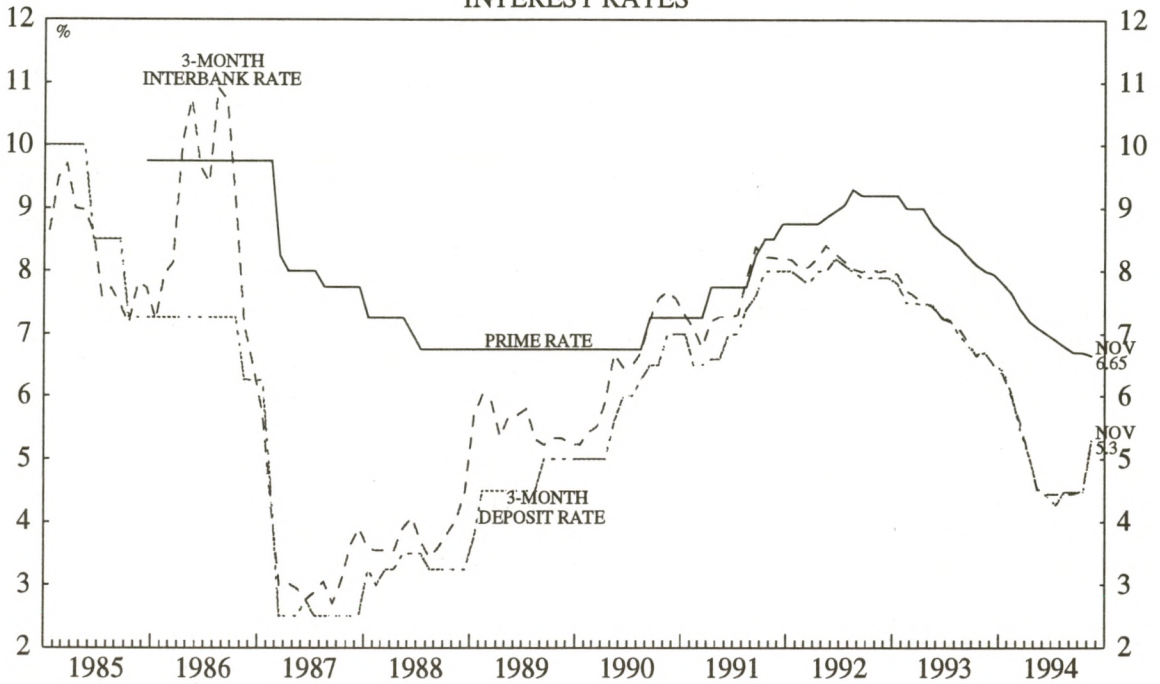
These tariff measures may also give rise to a one off boost to the overall demand for imports. Certainly, this together with the increase in government expenditure allocated to the upgrading of infrastructure, will likely generate a (policy included) upswing in import growth (which is currently growing at 34% yoy to August). This trend will likely contribute to a further deterioration in the trade balance in 1995, justifying the official expectations of the current account deficit next year.

Moves to liberalise both capital account transactions and the ease of transfer/remittance of income streams on assets held abroad, may sometimes yield an insight into the official expectation of the future market pressures on the local currency. However, in this budget the deregulation measures aimed at influencing capital flows are mixed. On the one hand (in moves to encourage the holding of Ringgit denominated assets) the government has (1) made it easier to repatriate overseas income (excluding service based income), (2) allowed non-residents to obtain property loans of any amount from domestic banks subject to certain conditions and (3) waived approval rules for foreign investment through non-resident controlled companies. Yet on the other hand, residents have been given more freedom to hold foreign currency. Exporters can retain a greater quantity of foreign currency earnings and overseas residents can now open foreign currency accounts both abroad and locally.

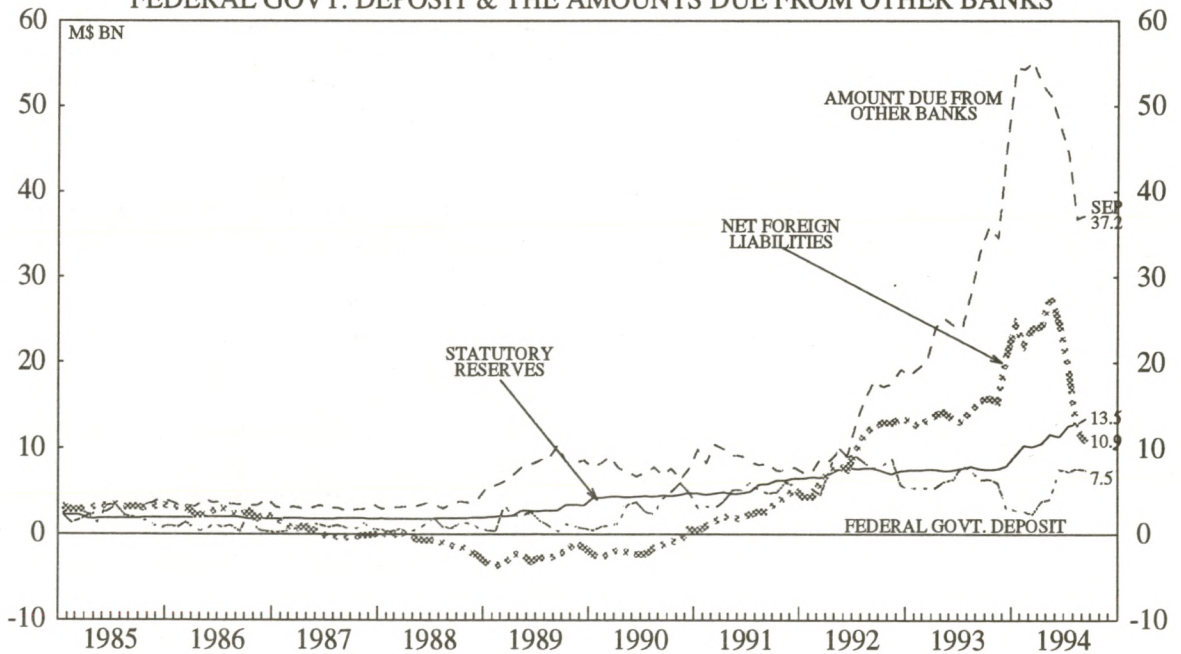
Being a pre-election budget, something of a "feel good factor" effect applies to some of the measures introduced, the most obvious being the reduction in income and corporate taxes which will deliver a one off boost to disposable incomes and corporate earnings growth. However, perhaps the most expansionary element to the 1995 budget is the liberalisation of some restrictions which apply to the extent to which households can "unlock" their savings held at the officially run Employees Provident Fund (EPF) and use them to purchase property.

The EPF has around 7 million members who contribute approximately RM7.4 bn p.a. Total funds under management weigh in at around RM78 bn. In 1982 the EPF, for the first time, permitted members to withdraw a percentage of their contributions to put towards the payment of a house. The withdrawal limits were last changed in 1992, when members were allowed to take out a maximum of 20% of their total contributions to buy a house (provided the maximum amount withdrawn did not exceed RM40,000). After the changes announced in the 1995 budget, a member can withdraw up to 30% of their contributions with no maximum ceiling in place. Now a large number of households will be able to withdraw sums in excess of RM40,000 to be used as the equity portion of a mortgage.

MALAYSIA: CHART 4
INTEREST RATES



MALAYSIA: CHART 5
STATUTORY RESERVE, NET FOREIGN LIABILITIES
FEDERAL GOVT. DEPOSIT & THE AMOUNTS DUE FROM OTHER BANKS



Unlike Singapore (where the Central Provident Fund (CPF) also permits savers to use a portion of their contributions towards the purchase of a house), the EPF will be involved in providing loans to some of its members as well (particularly for low and medium cost developments). Traditionally, the EPF has held most of its assets in the form of long term loans for Federal and State government development projects and as Federal Government securities. Now it will hold loans or mortgages to individual members.

This change in EPF rules is extremely positive for the residential property and construction sectors. It is also likely to be accompanied by an expansion in bank lending. This is for two reasons. Firstly, interest rates have been declining for the last couple of years and so the cost of financing a mortgage has followed suit (Chart 4). This is also the case in Singapore where the monetary authorities are beginning to face a similar expansion in lending following the partial liberalisation of the CPF scheme. Secondly, as explained in previous AMM articles and as will be discussed later, over the last two years commercial banks have accumulated a substantial proportion of their total assets in the form of short term low interest yielding loans to the central bank (Bank Negara Malaysia: BNM). As US interest rates continue to rise in 1995, these short term loans will likely expire and not be renewed, but converted to lending to the private sector. While domestic interest rates will be rising at that time, the prospective new demand which has emerged for housing finance will encourage banks to grant more credit to this area of the economy.

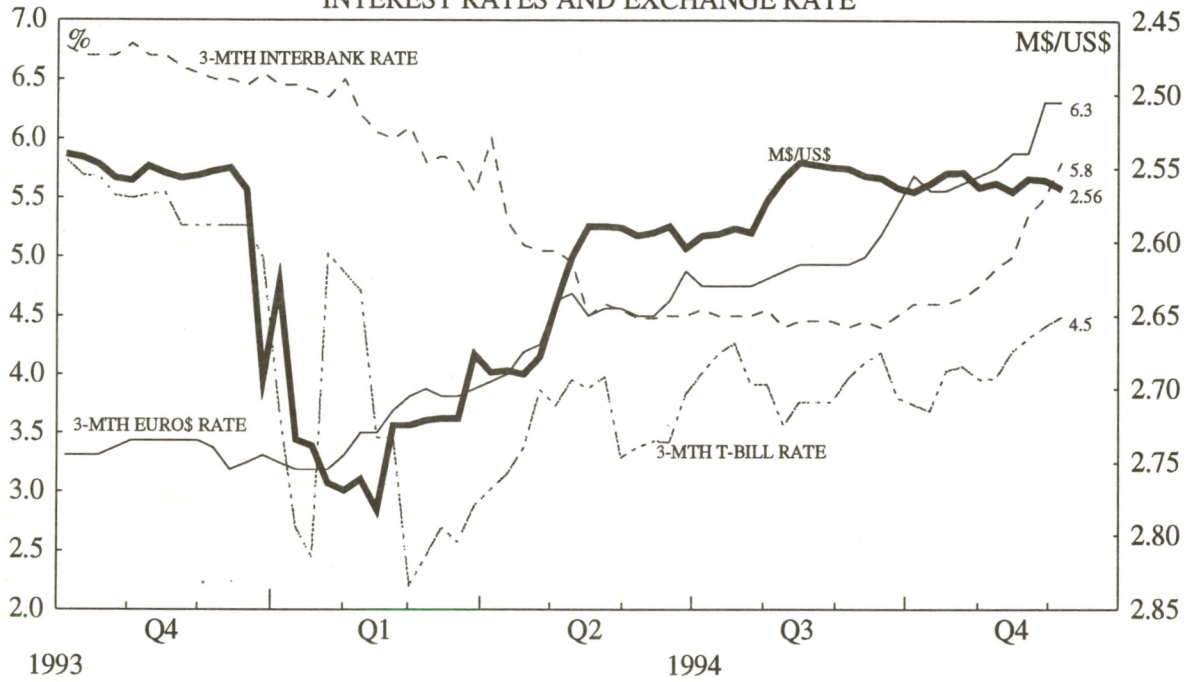
Monetary Policy in 1995

As explained in previous issues of AMM (see Vol. 17 No. 6 and Vol. 18 No. 4) from 1992 to mid-1994 BNM conducted a fairly slack monetary policy. This originated from its policy to conduct sterilised foreign exchange intervention to prevent the RM/US\$ from appreciating for much of 1992 and 1993, as US rates remained low relative to those in Malaysia. As shown in Chart 5 the net foreign liability position of the commercial banks (and foreign exchange reserve position of BNM) rose dramatically in 1993. While US short term interest rates remained at a substantial discount to those in Malaysia the upward pressure on the RM/US\$ remained strong and banks continued to accept a greater quantity of non-resident Ringgit deposits and to engage in offshore borrowing. This drove down local short term interest rates until they reached a level lower than their US\$ counterparts in 1994 (Chart 6). BNM imposed some controls to limit the capital inflows at the start of 1994, but by this time the arbitrage opportunities were greatly diminished (see AMM Vol. 18 No. 1). When these controls were relaxed some months later local short rates were already at a discount to those in the US and the upward pressure on the RM/US\$ had waned.

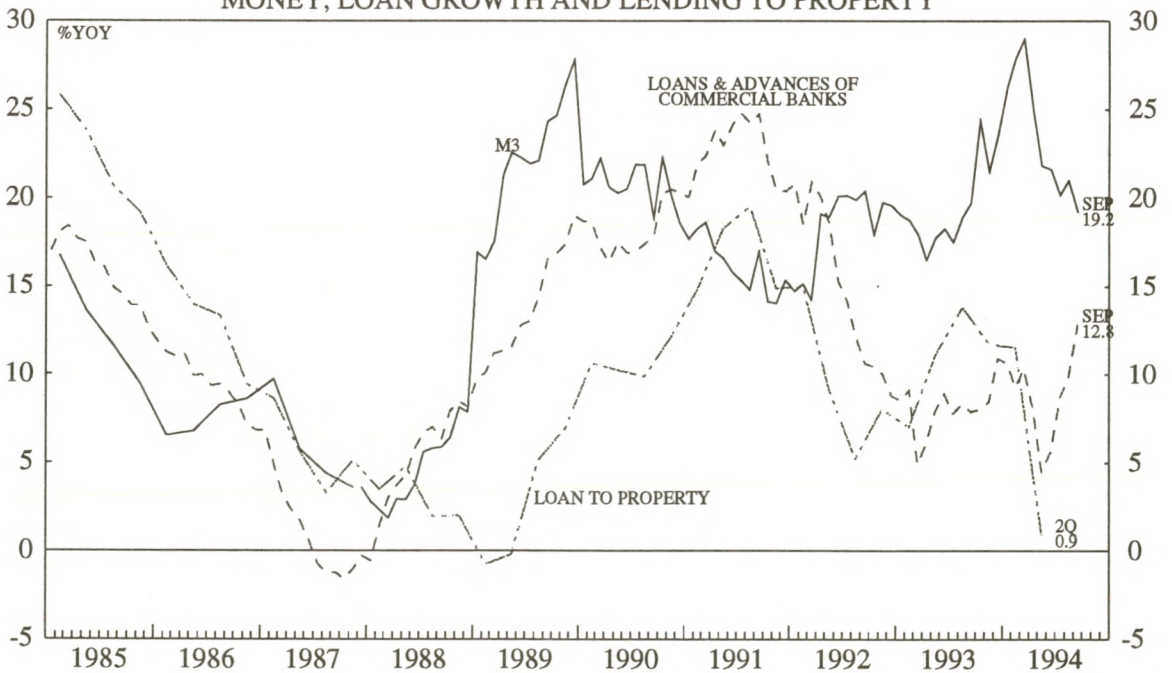
Because BNM conducted sterilised foreign exchange intervention, this whole episode has left the banks with an unusually large stock of loans to the central bank which continued to be rolled over at progressively lower interest rates in 1994 (Chart 5). These loans currently account for approximately 20% of banks' total assets (down from a peak of 23% in early 1994). They also represent a potentially large boost to the quantity of credit granted by banks to the private (or public) sectors (with an accompanying expansion in the monetary base). While BNM did not wish to see an explosion in bank credit, during 1994 it would not have been politically acceptable for it to allow the RM/US\$ to appreciate either (a necessary consequence of the higher interest rates needed to restrain credit).

In 1994 BNM has chosen to raise the statutory reserve requirement twice from 8.5% (at the start of 1993) to 11.5% today. In addition, the Federal government has raised its deposits at BNM by approximately RM4 bn since the start of 1994. Taken together, these

MALAYSIA: CHART 6
INTEREST RATES AND EXCHANGE RATE



MALAYSIA: CHART 7
MONEY, LOAN GROWTH AND LENDING TO PROPERTY



(draining) operations have prevented the decline in loans to the central bank (shown as amounts due from other banks in Chart 5) from translating into an expansion in lending to the private sector. Nevertheless a considerable liquidity overhang persists, and given that the general elections have still not taken place, it appears that (like many of the other central banks in the region with less opaque monetary policies) BNM will let the Federal Reserve Bank tighten monetary policy for it.

Consequently, higher US interest rates in 1995 and upward pressure on the US\$ vis-a-vis the RM should enable BNM to tighten monetary policy and drive up domestic rates so that they are more in line with those in the US as it supports or moderately appreciates the RM/US\$ rate. BNM would then be able to counteract the slowdown in the monetary base caused by this with the unwinding of its borrowings from the commercial banks. The degree to which this occurs is dependent on how much further the Federal Reserve raises US interest rates. However, it appears that this process may have already begun as short rates have recently risen by about 1% in the aftermath of the latest rise in US interest rates (Chart 6).

The impact of higher interest rates on credit growth is unlikely to be felt until Malaysian short and prime lending rates have risen significantly (later in 1995) although the outlook for credit growth will be determined by a mixture of two offsetting forces. Firstly the expectations of further rises in US rates by local banks will encourage them to raise their deposit rates on longer term Ringgit deposits and possibly restrain their extension of credit in local currency terms. This way they would be minimising the chance of being caught short of funds (if non-resident Ringgit deposits were to suddenly decline) and having to obtain more expensive credit from BNM using a lender of last resort type of facility. However, a second factor offsetting this would be that banks will still be able to extend more credit to the private sector albeit at higher interest rates, as their loans to BNM expire. In particular the liberalisation of EPF rules will present banks with additional custom as previously discussed, whose demand for longer term funds may be considerable even in an era of rising domestic interest rates. An expansion in total credit (and that extended for property transactions especially) appears likely in 1995, notwithstanding the subdued pace of credit growth in 1994 (Chart 7).

SUMMARY AND CONCLUSIONS: The economy is currently growing very strongly and this will likely continue for much of 1995, however, signs of a slowing may emerge by late 1995 or early 1996 as higher interest rates begin to bite. From the recent measures adopted in the budget the residential property sector, construction and the infrastructural development projects will likely be the main areas of stronger economic activity.

Following the latest hike in US interest rates, and given the ongoing trade account deterioration, short term interest rates have begun to rise (from their trough in 1994) at the current exchange rate of around 2.564. Further increases in US interest rates in 1995 will prompt further rises in local short term interest rates at the current exchange rate. This will tighten up short term liquidity conditions and give BNM the opportunity to wind down the substantial "excess" bank reserves (which represent a potential surge in credit). The relaxation in EPF rules will generate a rise in the demand for mortgages at current interest rates and so the stage appears to be set for an acceleration in bank credit next year. This would give BNM stronger grounds for taking explicit action to tighten up monetary policy further and thereby be (politically) able to appreciate the RM/US\$ and raise local interest rates (so that the premium over those in the US expands).

PAKISTAN EXTERNAL FRAGILITY REMAINS, BUT FURTHER FISCAL REFORM IN STORE

Introduction

Pakistan stands on one of the lower rungs of economic development. It has an acute lack of infrastructure, one of the lowest literacy rates in Asia and a large state sector which absorbs the lions share of the banking system's assets. In addition Pakistan is heavily dependent on one product: cotton, for much of its growth in exports, employment and production. However, this has gradually been changing. With a reformist minded government and support from international aid donors the prospects for sustainable and accelerating economic growth with the further necessary reforms continue to improve.

Following the entry of the government into a loan agreement with the World Bank in 1989, success in implementing the structural adjustment reform programme has been mixed. In a country like Pakistan, where "inward looking", protectionist and public sector dominated economic policies have been pursued for years, economic reform measures essentially need to be aimed at two areas: external trade and the public sector. Reform in both of these areas, but especially that directed at the public sector and its financing, is a prerequisite to the development of the financial system. As will be discussed later in this article, overall, since 1989 progress towards a more free market based financial system has been modest; partly a reflection of the slow pace of fiscal restructuring.

Progress on the external side of the economy has been more swift. The government has steadily reduced and standardised trade tariffs and barriers, the Rupee is now convertible on all current account transactions and (with the deterioration in trade performance in 1991 and in 1993) the government has enacted measures designed to attract greater quantities of foreign direct investment. For instance, both foreign and local firms can now raise foreign loans without government approval. The stockmarket is open to foreign investors, who can buy local shares without limit and repatriate capital and dividends freely. In addition tax free foreign currency accounts can now be opened by foreigners and Pakistanis paying premium interest rates (see Box 1 for a summary of major steps in economic reform in 1993-94).

Unfortunately in recent years the trade position has been weakened by poor cotton crops. This has induced a renewed awareness of the need for foreign investment (both from private and official sources). With the acceptance of more official (IMF and World Bank) aid in late 1993 (the IMF support package included US\$1.38 bn over a 3 year period) came the political commitment to further economic reform and the establishment of tough targets for the government deficit (of 4% of GDP) for this fiscal year (1994-95).

Since the Prime Minister, Benazir Bhutto regained office in October 1993 her government has embraced the notion of privatisation as a vehicle for implementing further economic reforms. As part of its privatisation drive, the government floated Pakistan Telecom (PTC) in October 1994, raising around US\$900 m; the largest euro-issue to emerge from the subcontinent yet. Further international private fund raising activities are likely in 1995 in the area of infrastructure as the government is especially keen to promote foreign (and private sector) involvement in this sector. This will soon be made easier as a sovereign benchmark for pricing future issues is about to come into being with the government's inaugural US\$200 m euro-note issue this December. (Standard & Poors rating agency has rated government debt at B+). Hence the stage appears set for further privatisation in

BOX 1

MAJOR REFORMS IN 1993-94

TRADE

- * Tariffs on imports have been progressively reduced since the mid-1980s. From 1988-94 the maximum rate was brought down from 125% to 80% (automobiles excepted). Other import charges such as surcharges and licences have been merged into the basic tariff structure.
- * The Rupee was made convertible on all current account transactions in July 1994 (with the government accepting Article VIII status under IMF Articles of Agreement).

FINANCE

- * Credit ceilings were abolished and replaced with a 30% credit-deposits ratio.
- * Statutory liquidity ratio (SLR) of 45% reduced to 30% in August 1993.
- * In February 1994, the State Bank Act was revised, ostensibly, giving the SBP more autonomy and a greater degree of independence over monetary control. The establishment of a Monetary and Fiscal Policies Coordination Board is considered a first step towards separating monetary and fiscal policy.
- * Other measures taken in 1993-94 to try and attract foreign investment included: the relaxation of restrictions enabling non-residents to trade freely in Federal Investment Bonds (FIB), WAPDA bonds and Treasury Bills through special convertible Rupee accounts. Non-residents can also invest in the limited amount of corporate debt instruments using Participation Term Certificates (PTC).

BUDGETARY

- * The introduction of income and wealth taxes in the agricultural sector. In addition, the sales tax was increased from 12.5% to 15%.

1995. Likely candidates for the chopping block include the WAPDA thermal power plants in Jamshoro and Kot Addu, the Sin Gas companies, Pakistan State Oil and possibly some more banks. However given the outlook for higher US interest rates in 1995, conditions in international capital markets will make future fund raising more difficult and more expensive than in 1994.

The policy move towards privatisation and further trade liberalisation is the kind of medicine this economy needs if it is to emulate the performance of its more successful East Asian neighbours in the future. In addition, if the financial sector is to break free from the tangle of State restrictions, this must be accompanied by a consistent decline in government financing requirements. The following sections discuss the impact of the State on the financial system, monetary policy and the recent changes in the monetary environment. This is followed by a brief review of the external sector of the economy, an area which affects Pakistan's international indebtedness position.

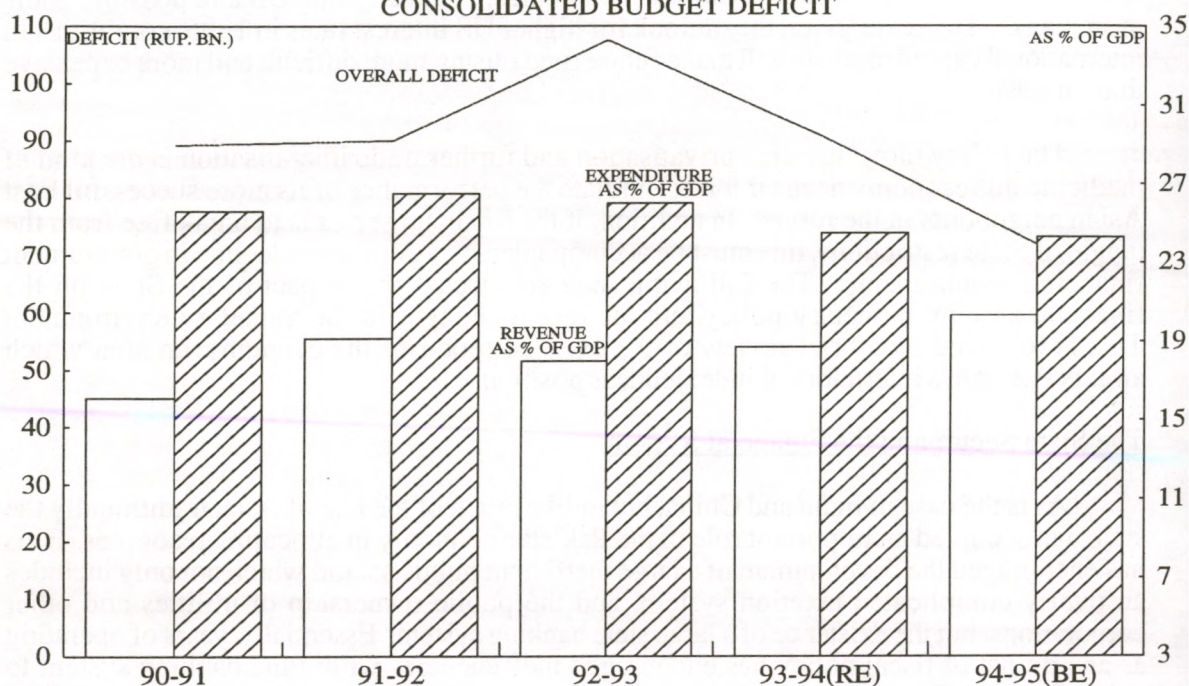
The State Sector and the Financial System

As is the case in India and China, but unlike much of the rest of Asia, traditionally the state has occupied an important role in the Pakistan economy in allocating resources. This has encouraged the development of a large inefficient public sector, which not only includes an overly complicated taxation system, and the public ownership of utilities and other corporations, but the existence of a large state banking system. Essentially, years of operating as an adjunct of fiscal policy has encouraged inefficiencies within the banking system to exist. Such inefficiencies include extending lines of credit to poorly performing companies and industries, both at the officially set maximum rate and at concessionary lending rates while offering a preset minimum of near to zero or negative rates of real interest on most maturities of deposit. In this environment monetary policy amounts to the setting of credit ceilings to various sectors of the economy and fixing a spectrum of prescribed deposit and lending rates. However, monetary policy is heavily influenced by the financing requirements of fiscal policy.

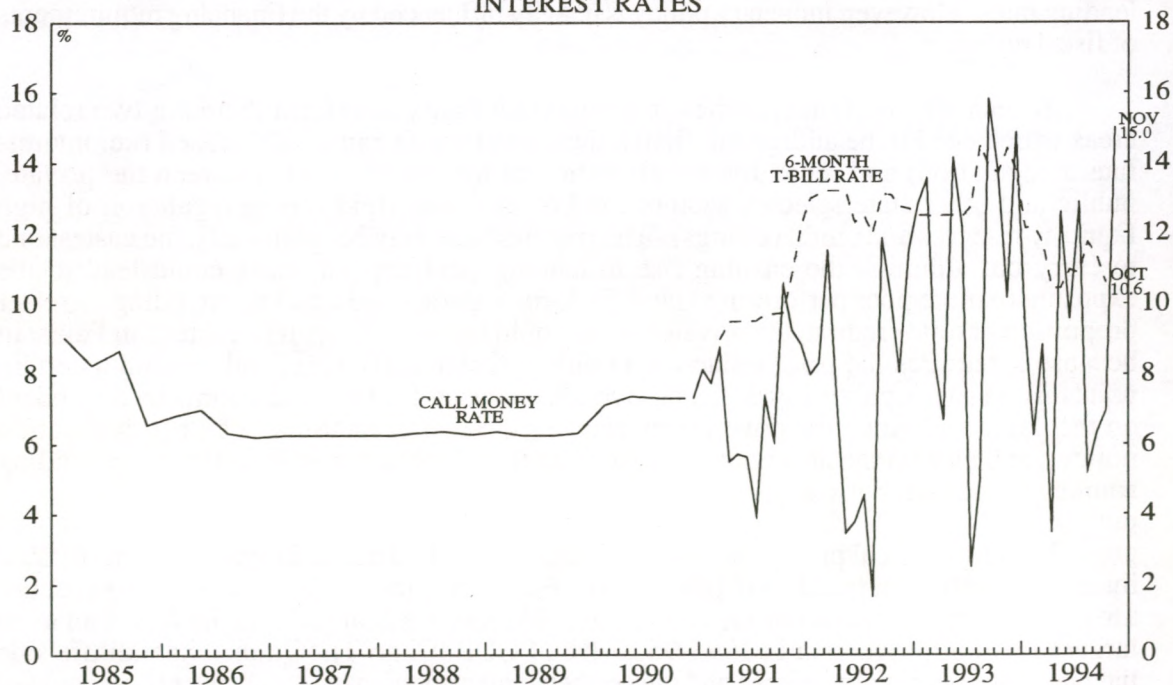
In such an environment when implementing financial reform there are two related areas which need to be addressed: firstly, the cost of credit can be liberalised (i.e. interest rate deregulation) and secondly, the allocation of the bank's assets between the private, public and other state selected sectors can be made less rigid (i.e. deregulation of high liquidity reserves and credit ceilings). The first measure may be, politically, the easiest one to carry out although the ensuing rise in lending (and deposit) rates could lead to the exposure of more poor performing loans. Reform in the second area i.e. extending a greater proportion of total credit to the private sector, could be more difficult to achieve in Pakistan because it requires the prior reduction in public sector borrowing, and beyond a certain point this is usually politically difficult. Overall, prospects for financial reform are dependent on the degree to which the government reduces the size of the State sector (privatisation policy), and also on the ability of the government to remove the artificially cheap funding sources for certain borrowers.

Turning to fiscal policy, the overall fiscal deficit (Federal & Provincial) deteriorated by around 20% from fiscal year 1991-92 to 1992-93 (to June). The government expects a 15% improvement in this deficit during 1993-94 from 7.9% of GDP to 5.8% and an even larger (20%) improvement in 1994-95 to 4% of GDP (Chart 1). On the expenditure side the two largest items are defense and interest repayments which have consistently accounted for around 25% of total expenditure each for the last 3-4 years. The government does not expect any substantial change in these proportions in 1994-95. However, much of the

PAKISTAN: CHART 1
CONSOLIDATED BUDGET DEFICIT



PAKISTAN: CHART 2
INTEREST RATES



improvement in the deficit is officially expected to come from higher tax revenue. While the sales tax was raised from 12.5% to 15% in 1993, the ability to collect taxes remains poor with tax evasion still a major problem. In addition these estimates are based on real GDP growth accelerating from an estimated 5.5% in 1994 to an (optimistic) 6.9% in 1995. It would be surprising if these targets were met, and much depends on the performance of the agricultural sector and on the actual revenue collected from the newly introduced taxes in this area of the economy. While there may be some improvement in the fiscal deficit in 1994-95, especially if further privatisations materialise, it is unlikely to be sufficient to lay the ground for more than a modest increase in the credit-deposit ratio in 1995.

Recent Changes in the financial system

Over the period 1991-94, the government has attempted to introduce a greater degree of competition for deposits by privatising banks and letting new ones into the market. In addition, as part of a financial reform package in 1991-92, the government decided to price its long and short term borrowing from the market using an auction based system. These became fully operational in 1992. Consequently, the rate on 6 month Treasury bills rose sharply from around 9% at end of 1991 to 13% in 1992 (Chart 2). Monthly auctions of T-Bills (6 month notes issued at a discount) and Federal Investment Bonds (fixed rate bonds with maturities between 3 and 10 years) are taken up by banks and by the National Savings Scheme. This scheme offers a variety of accounts and certificates, and had a total outstanding amount equal to Rp 162.4 bn in May 1994 (equivalent to approximately 25% of M2).

Another (modest) change in the financial structure occurred in 1993 when credit ceilings as a method of allocating credit to the private sector were abolished, only to be replaced by a credit-deposit ratio. Under the new system banks can lend up to a maximum of 30% of their deposits to (non-concessionary) private sector borrowers (and up to 40% of foreign currency deposits). This implies a reserve and liquidity requirement of around 70% despite the explicit statutory liquidity ratio of 30% of total deposits (5% to be held as SBP balances and the rest as mandatory holdings of government securities).

In 1991, the Government started the process of introducing a limited amount of competition into the banking sector by privatising 2 out of the 6 nationalised commercial banks: Muslim Commercial Bank (MCB) and Allied Bank Limited. Not surprisingly, these banks have spent the last few years providing for the bad or poor performing loans inherited from the time they were State run. In addition they (and MCB in particular) have emerged overstaffed, with unsustainably large branch networks. Further privatisations would likely result in an initial oversupply of networks and some consolidation along with a healthy demand for government paper as bad loans work their way out of the system. In 1992, 10 new private commercial banks entered the market (2 foreign and 8 domestic) increasing the total number of banks to 40.

A large number of Investment Banks and Development Financial Institutions (DFI) have emerged since 1989, many of which are government owned and extend credit to public and private manufacturers or lend for regional development projects. A number provide long term foreign currency loans to private firms. Two of these non-bank financial intermediaries are mutual fund companies. However as non-bank financial intermediaries most of these firms are restricted to accepting time/fixed rate deposits only and unlike the much larger commercial bank sector, these firms need only hold a minimum of 15% of their liabilities as government securities.

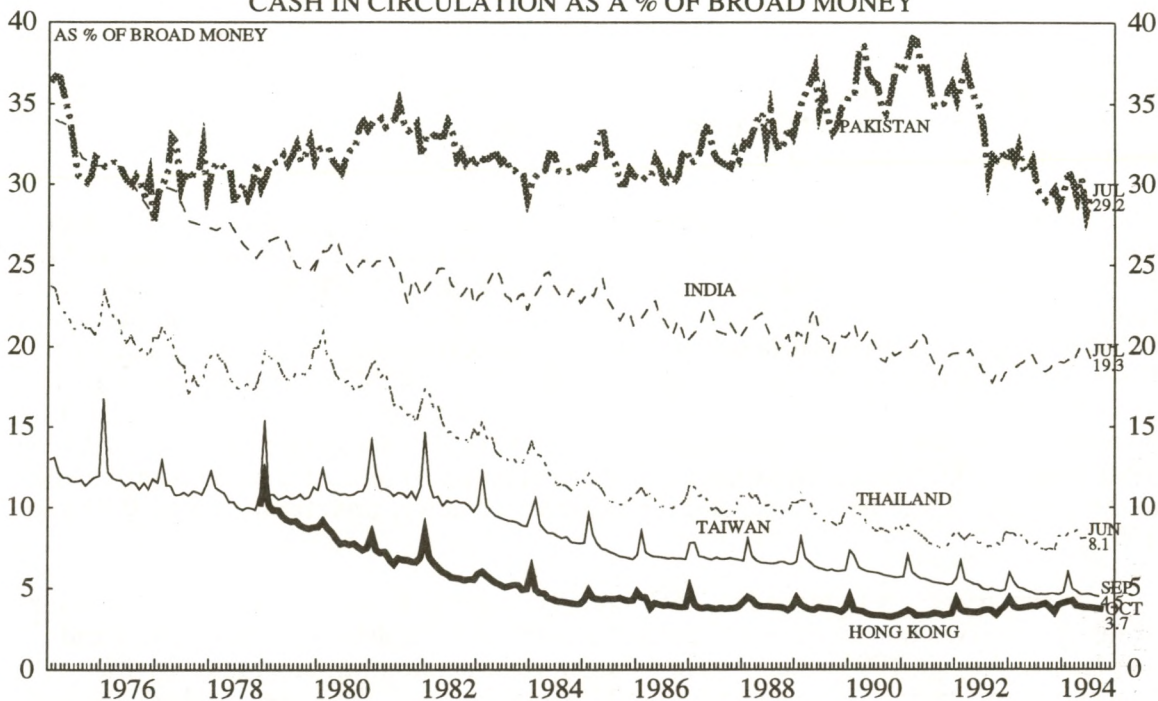
BOX 2

FINANCIAL SECTOR SOPHISTICATION

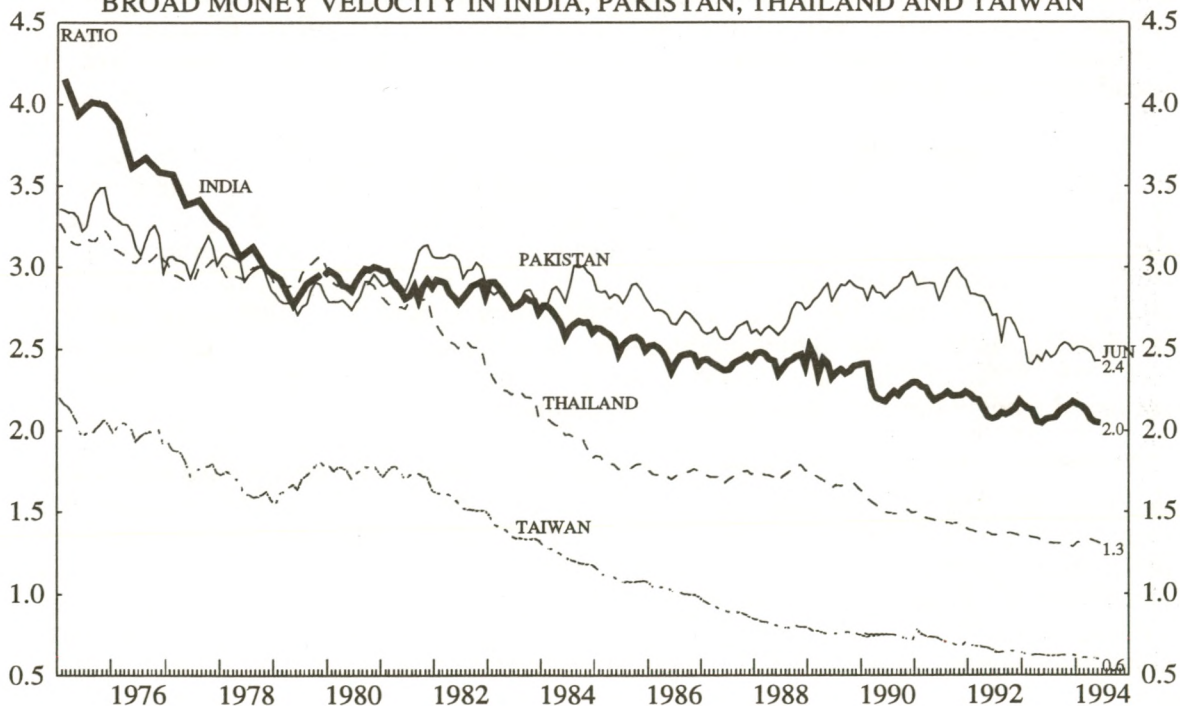
In economies where the state has played a dominant role in allocating resources and where a considerable amount of fiscal machinery exists (i.e. mainly in ex-communist countries and those shedding their socialist based economic policies) a sizeable black market has developed. Consequently cash is much more widely used in the settlement of debt and as a store of non-bank private sector assets. In Pakistan cash in circulation is around 50% of M1 and close to 30% of M2 (the broadest measure of bank deposits). This is in the same league as India and China (where the ratio of cash in circulation to broad money is currently around 21%). These ratios are much lower for the more financially developed (highly monetised) parts of East Asia where the State is less intrusive and where there are far fewer controls keeping deposit rates artificially low. For example in Thailand and Taiwan this ratio weighs in at around 8% and 4.5% respectively.

Notwithstanding the natural seasonal variations associated with holding cash, the extent of monetisation varies quite significantly across some Asian economies as shown in Chart 3. If economic reform remains on track over the next few years in India, China and Pakistan, then the incentive to conduct transactions in cash to the same extent (in an effort to avoid sometimes discretionary and arbitrary controls and taxes) will diminish. Indeed since the introduction of a greater element of competition for deposits in Pakistan and with its slightly higher deposit rates over 1991-92 there has already been a decline in the cash to broad money ratio in Pakistan. In the years ahead, as the trend of financial deregulation progresses and more private sector assets are intermediated through the banking system, (assuming little change in banks reserves at the central bank) the ratio of broader money to the monetary base will increase, i.e. the credit multiplier will expand in China, India and Pakistan. This would also be consistent with a more than proportionate rise in the real demand for money balances relative to real income, that is a decline in the velocity of broader money (notwithstanding longer term productivity gains). Chart 4 illustrates the kind of secular decline in velocity that has occurred over a 10-20 year period in the, now more financially advanced, parts of Asia such as Taiwan and Thailand. If the experience of Pakistan (and India) at least broadly conforms with that in these other Asian economies, then one would expect the rate of absorption of money to rise relative to incomes. With this structural change in velocity more money would be required to support a given inflation rate or, conversely, a given monetary growth would be consistent with a lower inflation rate.

PAKISTAN: CHART 3
CASH IN CIRCULATION AS A % OF BROAD MONEY



PAKISTAN: CHART 4
BROAD MONEY VELOCITY IN INDIA, PAKISTAN, THAILAND AND TAIWAN



The Monetary Outlook

While there has been some freeing up of parts of the banking system, the limits imposed on private sector credit and the officially set interest rates remain the dominant tools of monetary policy. The financial system remains rudimentary by the standards of other Asian economies. The intrusion of the State and artificially low interest rates continue to limit the disintermediation function of the banking system (see Box 2).

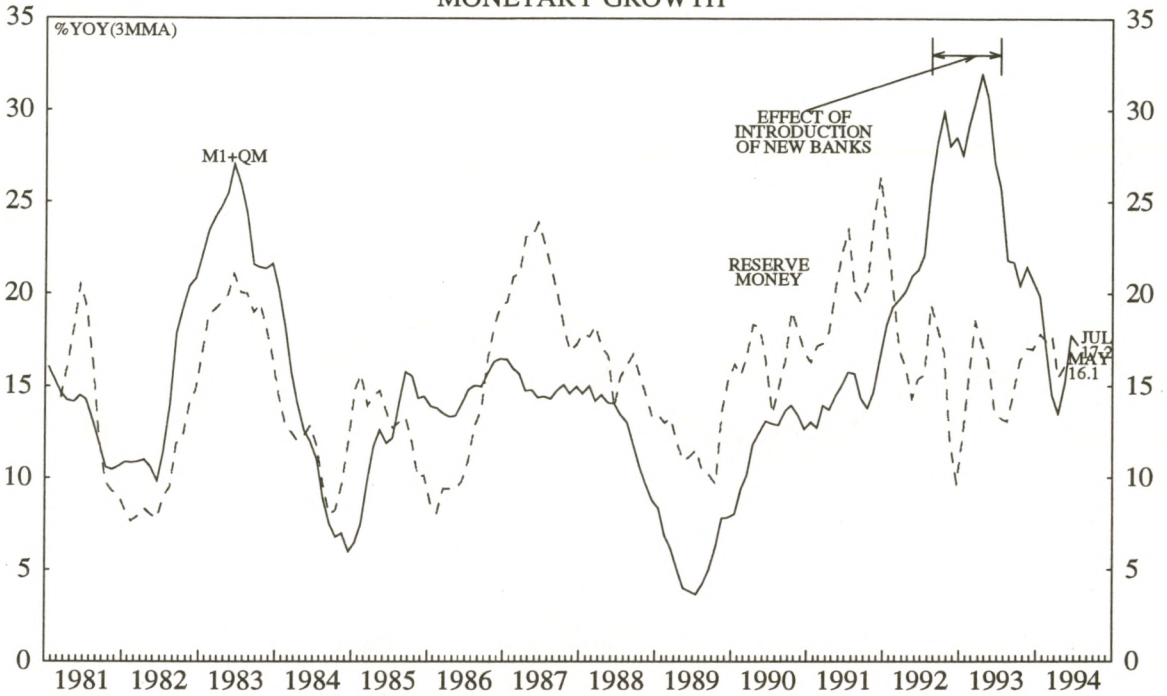
The economy has passed through one complete monetary cycle since 1990. Chart 5 shows the relatively close correlation between growth in the monetary base and that in M2. From 1990 to the start of 1992 the monetary base grew more rapidly as a result of the State Bank's increasing financing of a widening fiscal deficit (Charts 1 and 6). In addition, the holdings of government securities by commercial banks expanded over this time, Chart 7. Both reserve money and M2 accelerated through 1991, with M2 continuing to accelerate to a climax at the start of 1993. Bank credit which (in Chart 7) includes that granted to government bodies and concessionary rate borrowers also accelerated from the start of 1992 to mid-1993. Much of this dramatic expansion in broad money and credit is attributable to the introduction of new banks and the existence of newly privatised ones in 1991 and 1992.

Monetary policy tightened in 1993, initially as the SBP ran down its stock of foreign exchange reserves (as the trade and current account deficits deteriorated: Charts 8 and 9) and later in August 1993 when it raised the entire structure of interest rates by 2%. All concessionary lending rates were raised to 11%, maximum lending rates reached 22% and the short term repurchase rate was raised to 17%. However with the improvement in the trade balance and improved capital inflows from the end of 1993 onwards, in March (with the government's blessing) the SBP lowered the maximum lending rate by 3% to 19% while concessionary rates were raised again to 12%. Earlier this November the maximum lending rate was further reduced to 17%. This together with the influx of foreign capital has created a mildly stimulative monetary environment which has stabilised the declines in broad money and credit.

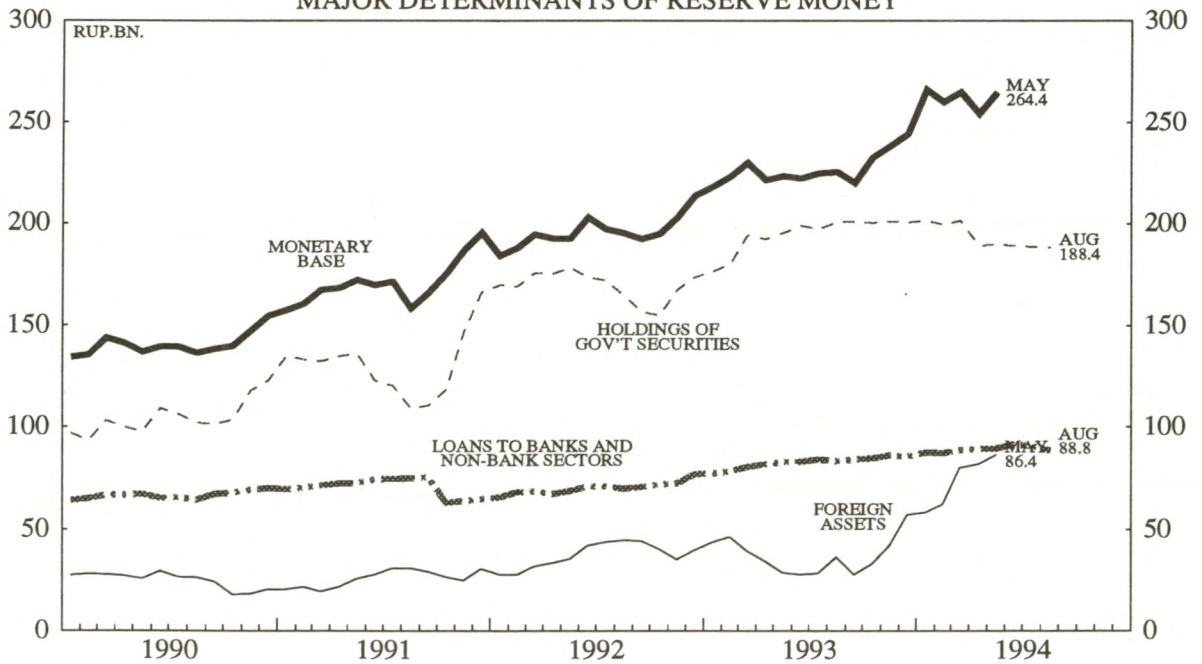
One outcome of these recent moves in interest rates has been a decline in interest rate margins. In 1994, the Government/SBP has sought to reduce its interest rate costs by reducing its 6 month T-Bill yields to 10-11%. It has been successful in doing this because the banks are effectively a captive market for Government debt. This (together with the declines in maximum lending rates) has occurred while fixed 6 month deposit rates have averaged 10-11% from 1991-94. The resultant contraction in these interest margins has prompted calls for either higher lending rates or a relaxation in the 30% credit-deposit ratio. As a result of this margin squeeze bank profitability is currently more dependent on fee based income (through bank guarantees and underwriting activities).

This year has seen a significant change in the sources of monetary base expansion. As shown in Chart 6, traditionally the biggest potential source of monetary base growth is from financing the fiscal deficit (as occurred at the end of 1991 and start of 1992) and not in the accumulation of balance of payments surpluses. However in the first half of this year and most likely in the second half as well this has begun to change. For the first time in over a decade it is the accumulation of a higher stock of foreign exchange reserves which has contributed significantly to monetary base growth and not monetisation of the fiscal deficit.

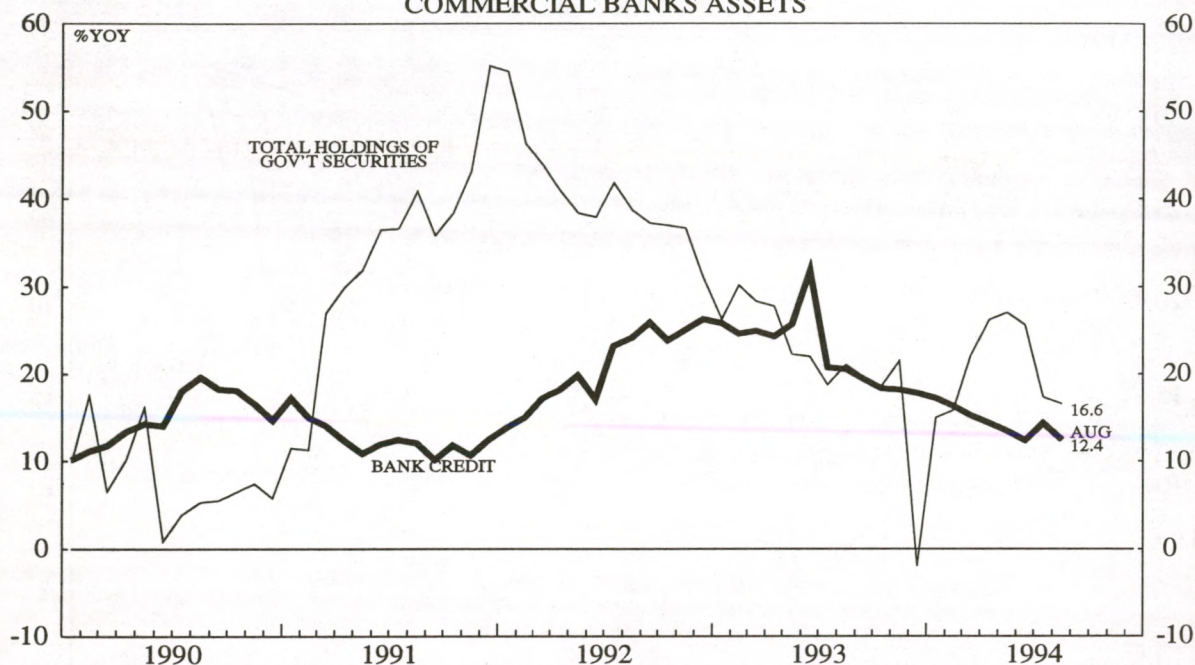
PAKISTAN: CHART 5
MONETARY GROWTH



PAKISTAN: CHART 6
STATE BANK OF PAKISTAN ASSETS/LIABILITIES
MAJOR DETERMINANTS OF RESERVE MONEY



PAKISTAN: CHART 7
COMMERCIAL BANKS ASSETS



The outlook for broader monetary growth is heavily dependent on the growth in the monetary base. With a government committed to a privatisation policy and to reducing its deficit further, monetary expansion which originates, from an additional influx of foreign capital appears feasible in 1995. However, as the cost of US\$ funds continues to climb the global capital market environment will be less appreciative of future fund raising activities from Pakistani entities. In addition, in May, Pakistan only had 2.3 months foreign exchange cover of imports and so although this is the highest level in 10 years, the buffer of official foreign exchange is still small. Consequently the economy will continue to remain vulnerable to a further deterioration in the current account deficit (although less so than in 1992). However, as in previous episodes of severe trade balance worsening (for example in 1988, 1991 or 1993 in Chart 6) the currency will be allowed to depreciate if, other things equal, the deficit deteriorates sharply in 1995.

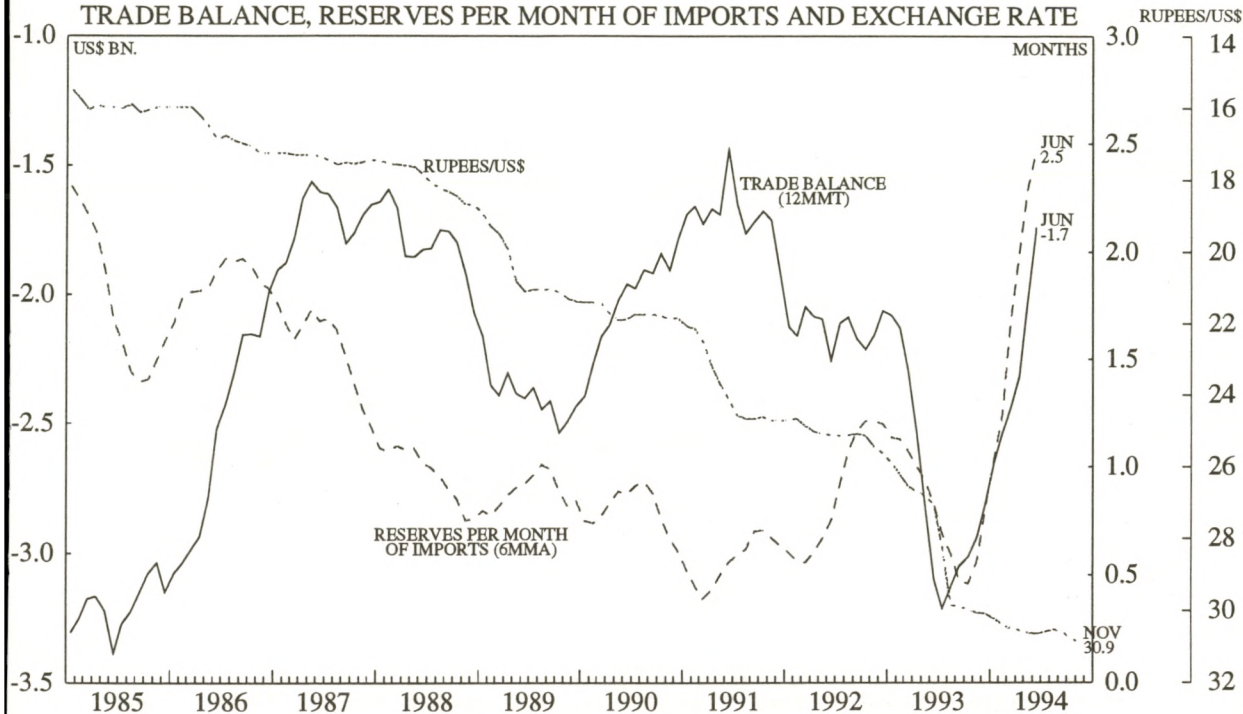
The External Sector

Although in the last couple of years the balance of payments has become a significant stimulus to the economy, it remains a potential source of weakness. This is largely due to the structure of industry (biased towards agriculture) and to the early stage of economic development of Pakistan (which requires significant importation of capital goods).

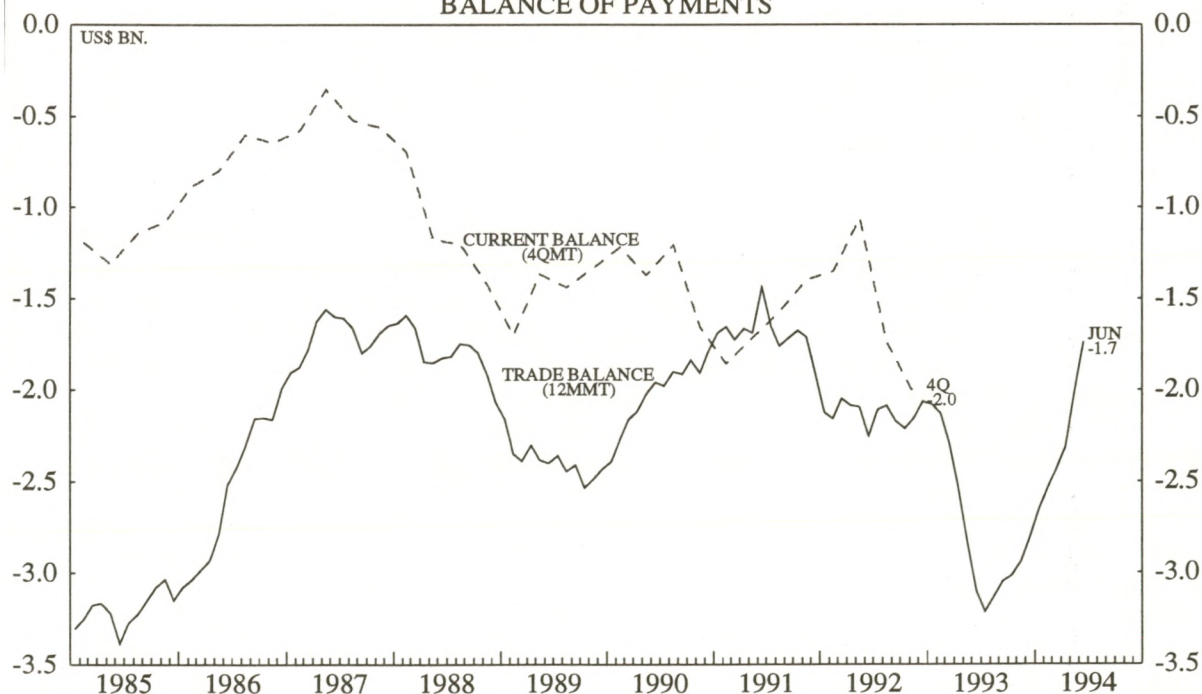
Pakistan is still predominantly an agricultural economy with this sector employing a shade over half the working population. The cotton and textiles industry dominates this sector. Despite consuming around 65% of its own production, Pakistan is one of the largest exporters of cotton in the world: around 60% of its exports are cotton or cotton based. Naturally such dependence on a single commodity leaves Pakistan vulnerable to the kind of supply side shocks that have occurred over the last few years (Chart 10). The spread of a virus coupled with floods have dealt a severe blow to exports as production has

PAKISTAN: CHART 8

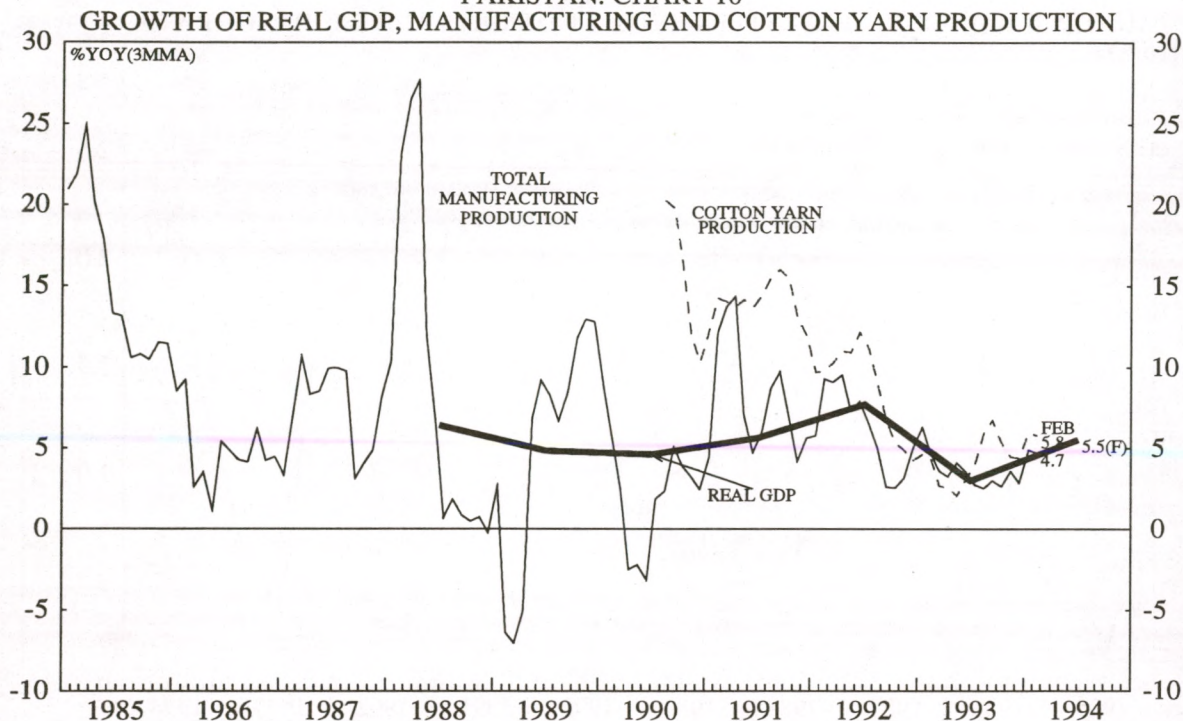
TRADE BALANCE, RESERVES PER MONTH OF IMPORTS AND EXCHANGE RATE



PAKISTAN: CHART 9
BALANCE OF PAYMENTS



PAKISTAN: CHART 10



fallen from 12.8 million bales in 1991-92 to around 7-8 million in each of the subsequent years (the harvest runs from November to January). Recently a slight shift in the structure of production has emerged towards substitutes and other higher value products such as leather goods and synthetic blended yarn. On the imports side, capital goods (machinery and transport equipment) are a significant component (around 30% of the total). These declined sharply from the latter half of 1993 to the first half of 1994, but will accelerate in 1995 in response to the State directed and foreign funded infrastructure projects set up this year.

Although the export performance has been on a decline since 1991, the consequent deterioration in the trade deficit has been offset by weak import growth in late 1991 and more recently in late 1993 (Chart 8). The government was particularly keen to halt the deterioration in the current account deficit last year (which expanded to 4.7% of GDP from 4.2% in 1992) and which was reaching unfinancable proportions. Capital inflows were insufficient to stem the drain on foreign exchange reserves, which were whittled down to around 5 weeks of imports by end 1993 while the Rupee/US\$ rate depreciated 16% to 30.08 that year. The stock of external debt expanded by 16% in 1992-93, a trend largely driven by the unplanned fiscal overspending in 1992-93. These trends reversed in 1994 as the trade deficit improved while capital "inflows" increased dramatically, boosting foreign exchange reserves at the central bank. Some of this foreign capital is official aid (planned in March 1994) and is allocated to infrastructure projects over 1994-95, while the remainder is direct and portfolio investment enabling the largest and most creditworthy of Pakistans conglomerates to raise funds offshore. In response to the balance of payments improvement from late 1993 onwards, the Rupee/US\$ exchange rate (convertible on current account transactions since July 1994) has stabilised.

SUMMARY AND CONCLUSIONS: Monetary policy is easing in the sense that interest rates have been falling in the second half of 1994 (both on government debt and on non-concessionary private sector lending) and due to the stable (and possibly mildly accelerating) monetary base growth in the second half of the year. Against this background the local equity market should see modest gains in 1995, if not remain comparatively stable. Another poor cotton crop this year would dampen exports, industrial production and produce a deterioration in the current account. While a greater buffer of official foreign exchange reserves exists today than in 1992 a rapid current account worsening in 1995 would probably force the SBP to let the Rupee depreciate after a time. In this respect, official commitment to the current exchange rate is fragile.

The government has taken significant steps in deregulating the economy including: relaxing various trade barriers, making the exchange rate convertible on current account transactions and introducing tax incentives to stimulate private investment. In addition the Government has already been successful in encouraging foreign investor participation in various power projects. A continuation of this deregulatory trend is crucial to maintaining the influx of private sector capital in 1995. Unfortunately because of the continued upward climb in US\$ short interest rates the international capital markets are likely to require much higher yielding debt/equity instruments in 1995, than was the case in 1994.

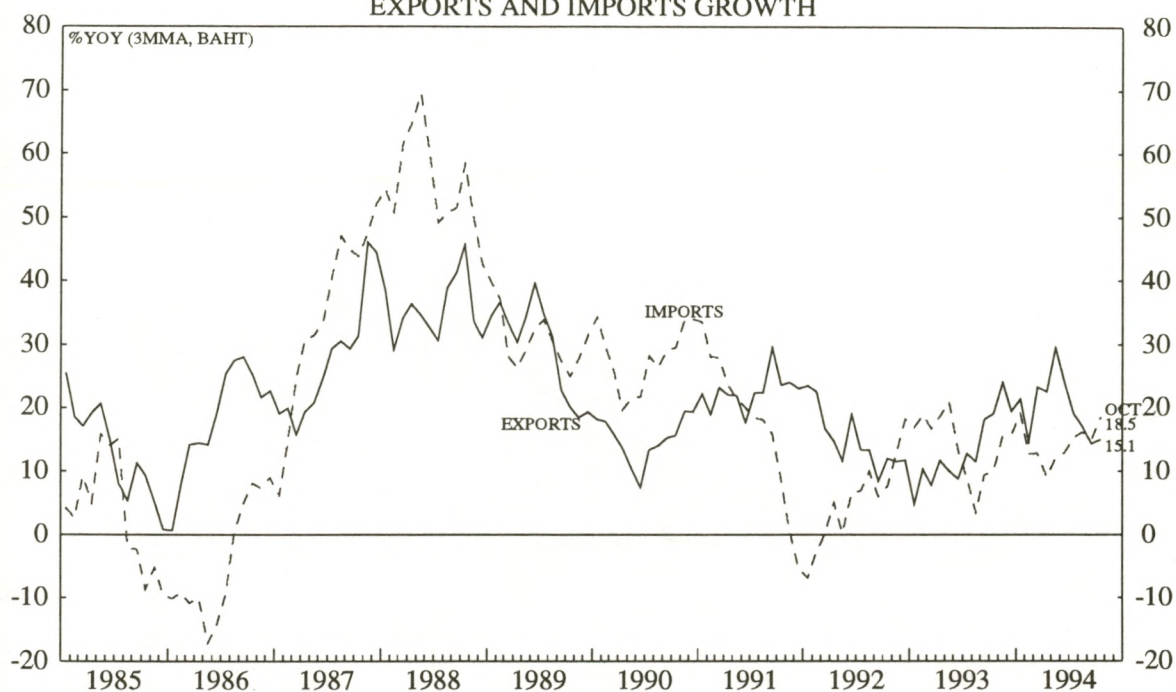
THAILAND TACKLING CAPITAL INFLOWS WITH BANK SUPERVISION

Several Southeast Asian countries have had difficulties coping with the monetary impact of large-scale foreign capital inflows attracted by successful rapid economic growth. More specifically, the foreign capital inflows have been attracted by the high potential rates of return on capital in economies with scarce capital and abundant and still relatively cheap labour. The Purchasing Power Parity (PPP) and Factor Price Equalisation (FPE) Theorems suggest that capital and trade flows will in the long run eventually equilibrate the levels of goods prices and factor prices between open economies, through changes in either the prices themselves and/or in the exchange rate. In the medium-term, however, the continued rapid economic growth of several of these countries is in large part predicated on maintaining a relatively stable macro-economic environment with low relative unit labour costs in order to attract an appropriate amount of foreign capital to fill the domestic savings-investment gap. But this is an increasingly difficult balancing act of macro-economic management given the increasing volumes, mobility and resulting volatility of short-term capital flows and the long-run pressures towards PPP and FPE.

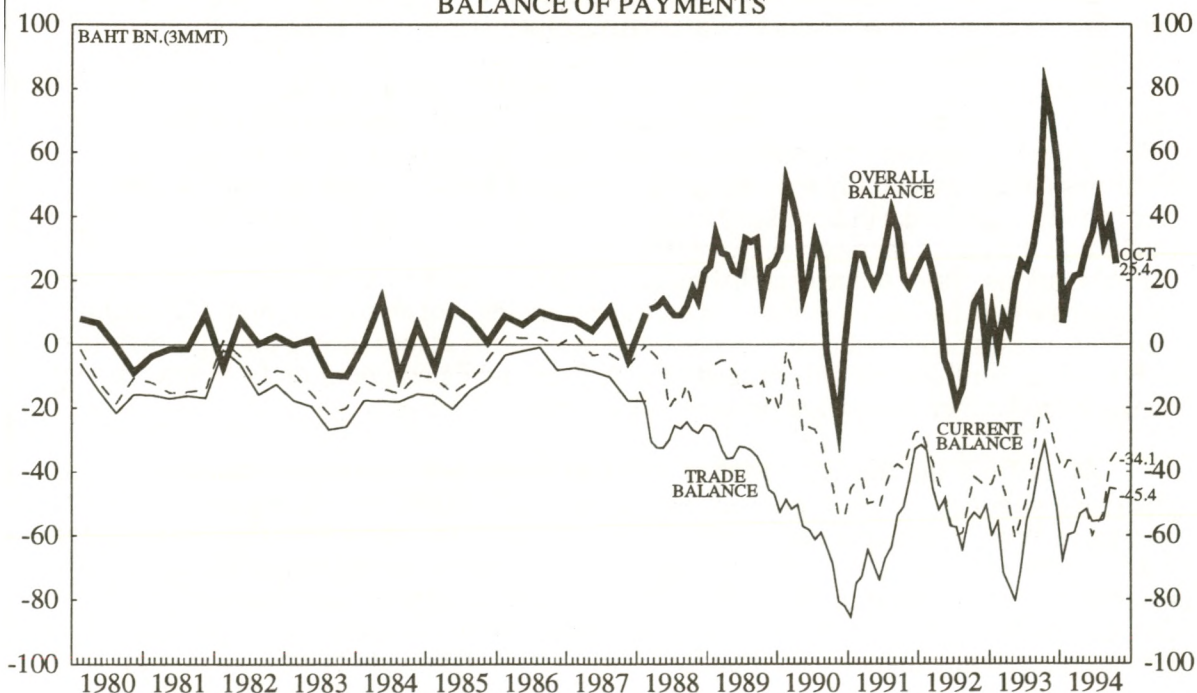
The authorities in these countries have tried various frameworks of monetary policy in their pursuit of this holy grail of long-term rapid growth with low inflation. Taiwan and South Korea have opted for tightly regulating the inflows and outflows of foreign capital in order to maintain greater independence of monetary management. Singapore and Indonesia have opted for targeting a gradually appreciating and a gradually depreciating exchange rate respectively, while maintaining an open capital account and accepting the level of interest rates dictated by covered interest rate parity. Malaysia and the Philippines have pursued somewhat erratic policies as regards both the exchange rate and the openness to short-term capital flows. Hong Kong and Thailand have both had fixed exchange rates (to the US\$ and a US\$-dominated basket respectively) for more than a decade. During this time Hong Kong's external trade flows, let alone its capital flows which are not even measured, has increasingly dwarfed the size of the domestic economy (in 1993 exports and imports of goods and non-factor services amounted to 175% and 171% of GDP respectively), and the authorities recognise their inability to affect monetary conditions beyond smoothing out short-term volatility in liquidity and short-term interest rates.

Thailand's economic success has been a text-book example of export led growth, and as a result the magnitude of its external flows has increased dramatically over the past decade. Exports of goods and non-factor services rose from 26% of GDP in 1983 to 40% in 1992 and imports of goods and non-factor services from 33% to 47% of GDP over the same period. Moreover, even at these high levels relative to GDP, Thailand's exports continue to grow more rapidly than OECD import demand (i.e. Thailand continues to gain export market share), although imports grow even faster and result in sizable trade and current account deficits (see charts 1 and 2). This domestic savings-investment imbalance has, however, been more than compensated for by inflows on the capital account, pushing the overall balance of payments into an annual surplus every year since 1984. Along its export led and foreign investment assisted growth path, Thailand has had to open up its economy and allow itself to become increasingly dependent on the rest of the world (for export markets, for imports, and for capital to fill the savings-investment gap); and having lifted virtually all exchange controls (except that Thais cannot buy foreign securities and foreigners cannot buy land in Thailand or export antique Buddha images), it will be very difficult but not entirely impossible for the authorities to reimpose them.

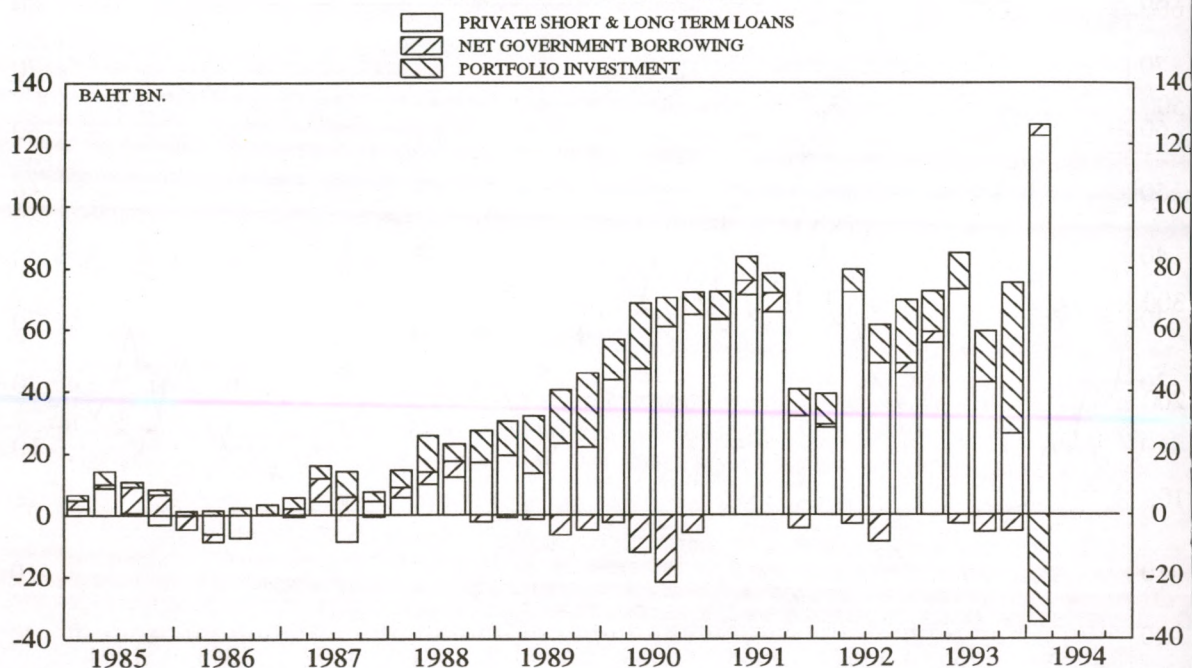
THAILAND: CHART 1
EXPORTS AND IMPORTS GROWTH



THAILAND: CHART 2
BALANCE OF PAYMENTS



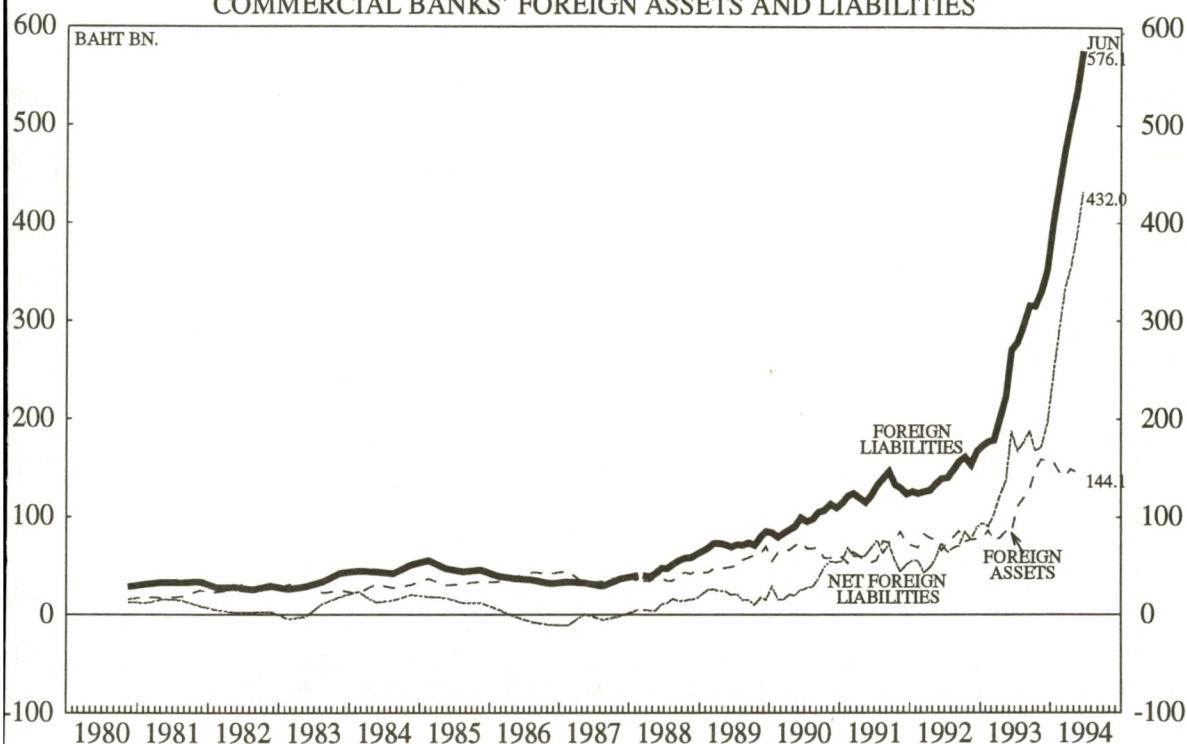
THAILAND: CHART 3
NET CAPITAL INFLOWS



Although the overall magnitude of the capital account flows is still much smaller than that of the trade flows, the rate of growth and volatility of composition of the capital flows has been even more dramatic, especially so in the past two years (see chart 3). This has been due to a number of factors. Externally, unjustifiably low US interest rates in the second half of 1993 pushed sizable flows of capital across the Pacific Ocean in search of higher rates of return, while rising interest rates in 1994 put a damper on inflows of US capital. On the domestic scene, various financial liberalisation measures including deregulation of interest rates and the establishment in March 1993 of Bangkok International Banking Facilities (BIBF, essentially separating and deregulating the foreign currency activities of local and foreign banks in Bangkok) made it easier for a much wider range of Thai entities (including the banks themselves) to reduce their funding costs by accessing international capital markets. Prior to the establishment of BIBF it was only very large Thai corporates and banks which had access to foreign currency funding, but now even small and medium-sized businesses had the choice between borrowing either at local prime rate plus margin or at Euro-\$ rates plus a margin, hedged or unhedged; while competition from new foreign banks led to further downward pressure on margins.

Apart from the fourth quarter of 1993, in which net portfolio investment was the positive component of the capital account surplus (although it turned negative in the first quarter of 1994), the main component of the capital account inflow over the past two years has been the external activities of the banking system, and in particular of the new BIBFs. Prior to the introduction of BIBF, Thai banks' ability to expand their balance sheets was constrained by prudential requirements (statutory reserves, liquidity and capital adequacy ratios, etc.) relating to their Thai Baht deposit base, the aggregate of which (i.e. the money supply) could be controlled more or less by the Bank of Thailand (BoT). As BIBF foreign currency business was not subject to reserve requirements or withholding taxes on interest income, the introduction of BIBF allowed the banks to expand their foreign currency loan

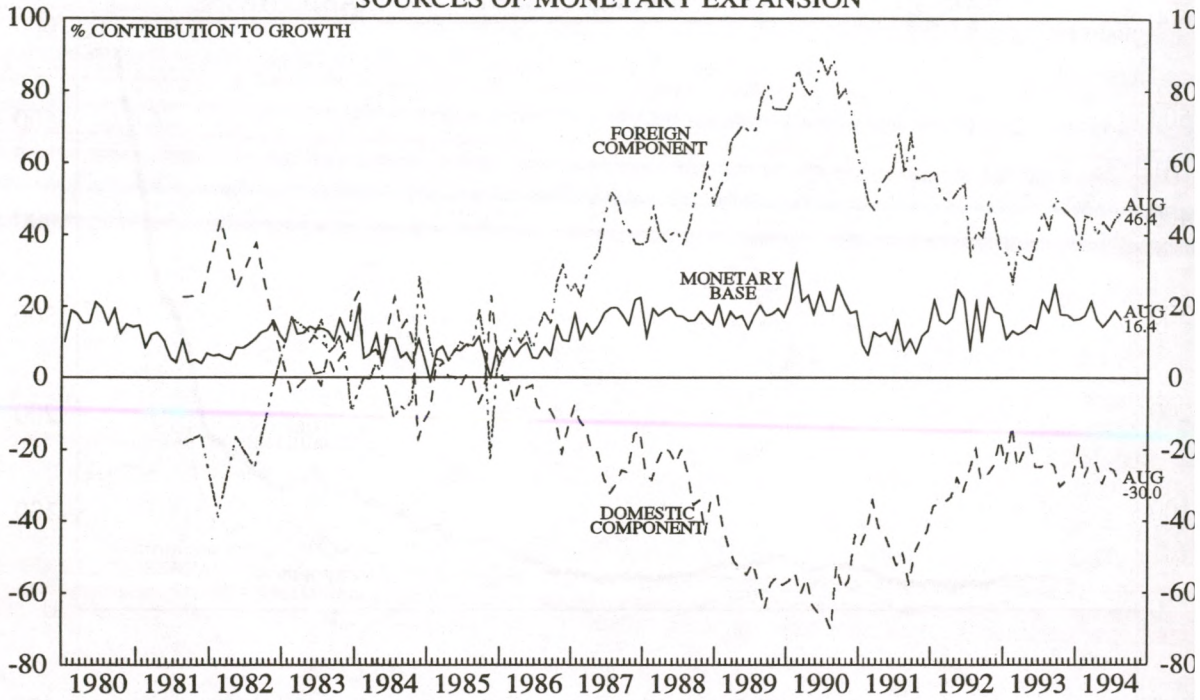
THAILAND: CHART 4
COMMERCIAL BANKS' FOREIGN ASSETS AND LIABILITIES



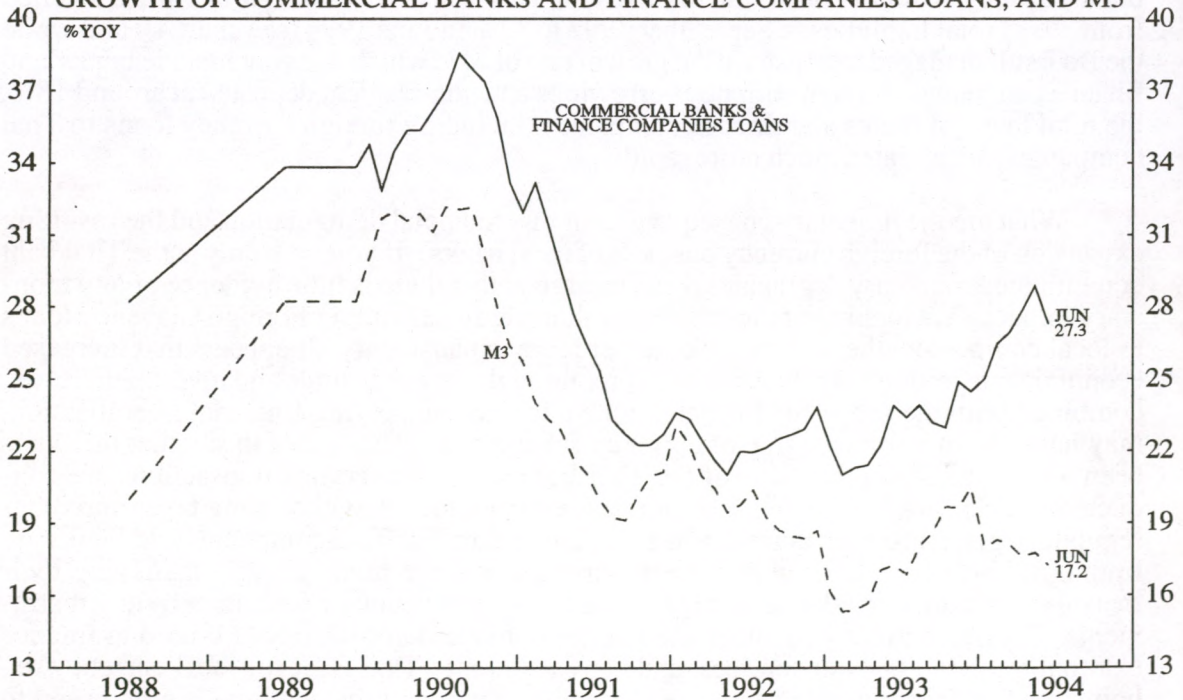
book virtually without constraint. As a result, Thai banks' net foreign liabilities swelled from 3% of total liabilities in September 1992 to 12% in June 1994 (see chart 4); and while the BoT still managed to constrain the growth rate of M3 (which does not include banks' and finance companies' foreign currency borrowings and non-resident deposits) at around 18%, the total loans of banks and finance companies (including foreign currency loans to Thai companies) accelerated much more rapidly.

What are the monetary consequences of this financial deregulation and the resulting expansion of the foreign currency business of local banks? If you look only at the Thai baht denominated monetary aggregates it can be argued that there is little evidence of any monetary impact. Yet looking at the rapid growth in credit (including Foreign Currency loans to local companies) the picture looks rather more expansionary. It appears that increased economic integration with the external sector through growth in trade and investment flows, combined with the scope for financial innovation accompanying financial liberalisation, may have led to a some degree of currency substitution. That is not to say that there has been a loss of faith in the value of the Thai Baht and that everyday transactions are conducted in US\$. Rather, the absence of reserve requirements, withholding taxes and other regulatory grit on foreign currency banking has meant that Thai companies and banks are finding it cheaper to borrow in foreign currency, and are more actively managing their treasury operations to take advantage of the higher efficiency of foreign currency instruments. Foreign currency balances need not be converted into Thai baht if used to finance external trade in goods or services, and conversion into Thai Baht for local currency denominated transactions need not take place until payment falls due (and can be timed to take advantage of even modest exchange rate fluctuations). If such currency substitution is

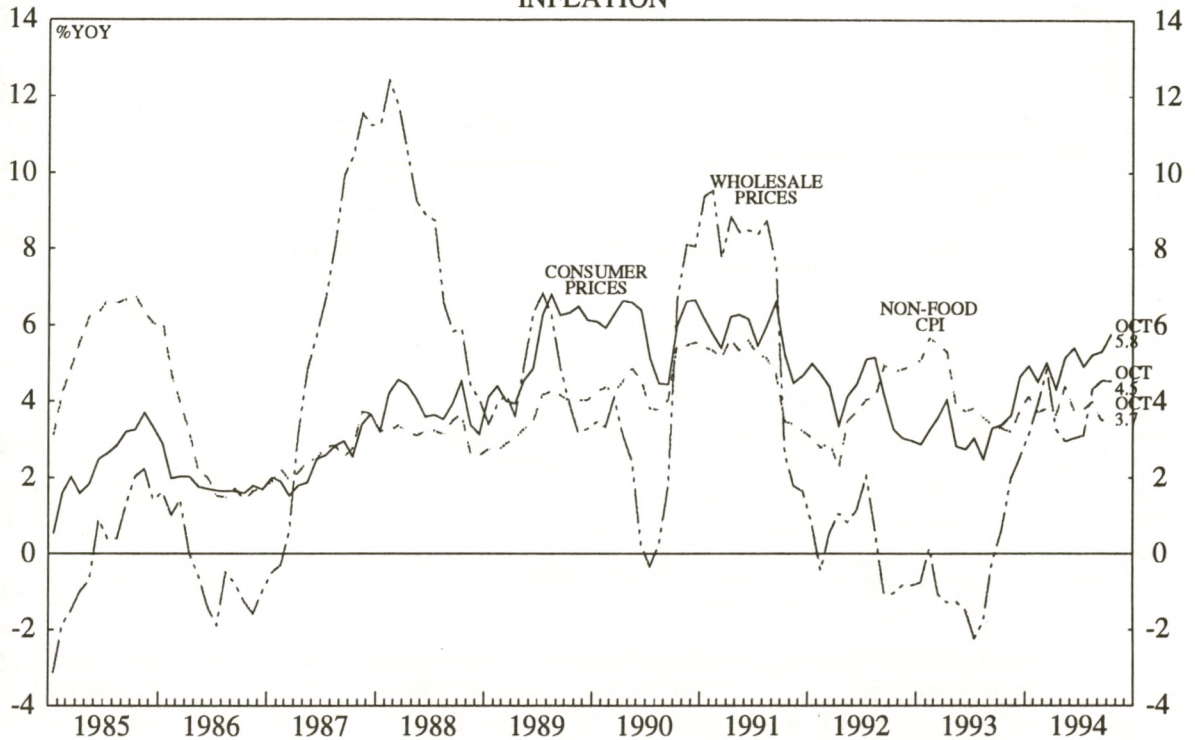
THAILAND: CHART 5
SOURCES OF MONETARY EXPANSION



THAILAND: CHART 6
GROWTH OF COMMERCIAL BANKS AND FINANCE COMPANIES LOANS, AND M3



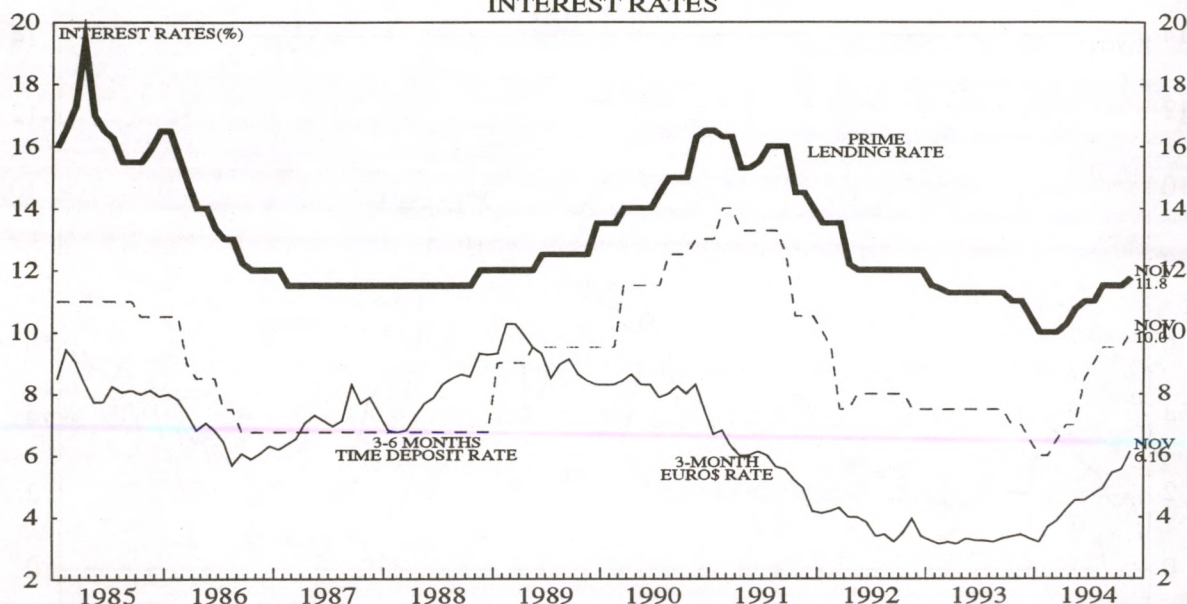
THAILAND: CHART 7
INFLATION



indeed taking place, it is equivalent to a secondary velocity shift from broad money M3 to an even broader and at present unmeasured aggregate - M3 + foreign currency and non-resident deposits. The consequences obviously depend on the growth rate of this wider aggregate, but with its main counterpart (broad credit including foreign currency loans) growing at 27%, one would expect it to be quite stimulative if not inflationary. Inflation has so far been relatively muted (see chart 7), although since July the headline CPI inflation rate has been above 5% - previously regarded by the BoT as an "unacceptable" level.

So what can the BoT do to control monetary conditions? In theory there is very little it can do. It has effectively committed itself to pursuing several conflicting policy objectives: a fixed nominal effective exchange rate (which may well be undervalued), an open capital account (in order to attract foreign investment) and domestic macro-economic stability conducive to steady growth with low inflation. Although the BoT has plenty of reserves with which to defend a target exchange rate, its ability to sterilise any expansionary foreign exchange intervention (i.e. to soak up capital inflows) is severely limited by the absence of domestic government debt securities (as the budget has been in surplus for years) and the structure of its own balance sheet (liabilities are mainly cumulative fiscal surpluses, while assets are almost exclusively foreign exchange reserves). The conflicting policy objectives also lead to ambiguous policy implications for domestic interest rates, which should either follow (until recently) low international interest rates or (still) higher domestic rates of return on capital. Allowing interest rate parity would be an inappropriately loose stance against domestic inflationary pressures, while higher domestic interest rates in line with internal rates of return can now be disintermediated much more widely through foreign capital inflows, which in turn adds to liquidity and inflationary pressures. In theory, therefore, one of the conflicting policy objectives will have to be abandoned.

THAILAND: CHART 8
INTEREST RATES



So what is the BoT doing to control monetary conditions? In practice, quite a lot. On the political front, it has started to soften up on some of the conflicting policy objectives by acknowledging (a) that some exchange rate flexibility might be useful, (b) that some undesirable side effects may have resulted from financial liberalisation in general and BIBF in particular, and (c) that CPI inflation in excess of 5% may not be that unacceptable. In monetary operations in November 1994, the BoT indicated to banks that it will not provide liquidity to relieve seasonal money market shortages, thereby driving 3-month deposit rates up (as smaller banks scrambled for funds to gap impending seasonal cash shortages) and call rates down (as the resulting foreign inflows was placed on call). Besides scaring some smaller banks this posturing and the likely resulting boost to short-term liquidity was hardly an unmitigated triumph of monetary management. In the foreign exchange market, several players have reported structural breaks in their estimates of the BoT exchange rate basket, suggesting that the BoT is allowing greater volatility in the exchange rate in order to discourage out-right arbitrage of interest rate differentials.

However, most of the Bank of Thailand's actual actions have have not been through conventional monetary policy tools, but rather through the much less obvious tools of banking regulation and supervision. Thai banks are very closely supervised, and have to report regularly and in great detail to the BoT on their business plans, including their lending target for different sectors. In additions to exhortations in private, the BoT has publicly indicated its displeasure at the proportion of bank loans going into "unproductive sectors" such as property development and consumer lending, and warned of further action to come. On the foreign currency side, the BoT tightened up the prudential limits on banks net foreign liabilities and net open foreign currency positions on 4 November 1994. Although the new limits do not yet bite for the system as a whole (only a handful of smaller banks are at or above the new limits) the move has preempted any further explosion of net foreign liabilities and sent a clear signal to the banks to moderate the expansion of their foreign currency business. The BoT has also tightened up provisioning requirements for foreign currency loans to Thai corporates, requiring 100% provisioning when the loan falls one week into arrears (compared with upto 6 months grace for Thai Baht loans).

The BoT has also announced that a review of the financial system in general, and of the role of BIBF in particular, will be published early next year. The announcement of such a review suggests that the BoT is getting quite concerned about the monetary impact of previous financial liberalisation measures, and feels it is running out of effective policy instruments. The package will probably try to enhance BoT's means and scope for monetary control by throwing some grit in the wheels of the BIBF foreign currency banking machinery. Measures to curtail BIBF foreign currency lending to Thai corporates might include requirements of high credit rating, full hedging of currency exposure by both the bank and the company (especially if the loan is not for payment for imports), or even overt grit like a value-related stamp-duty and/or statutory reserve requirements on foreign currency banking activities. Any restrictive measures is likely to be accompanied by encouragement (if only verbal) for Thai banks to use the BIBF to for lending to poorer neighbouring countries to make Bangkok the international financial centre for those new emerging markets. Measures to curtail expansion of non-resident deposits might include imposition of withholding tax and/or statutory reserve requirements for such deposits. Besides curtailing foreign currency activities, the review is likely to contain measures to discourage lending to "unproductive sectors" (e.g. higher collateral requirements or alternatively indemnity insurance requirement for property related lending) and encourage lending to "productive sectors" (e.g. official credit guarantees). Another means of sterilising the capital inflows would be to encourage offsetting outflows by allowing Thais to invest in foreign securities, probably through mutual funds initially. The review is unlikely to contain any really dramatic moves like a complete floating of the currency (although a move towards more flexible exchange rate targeting might be on the cards) or a closing of the capital account (although modest back-door 'prudential' capital controls appear likely).

SUMMARY AND CONCLUSIONS: Prudential measures implemented recently and further ones likely to be announced in the review of the financial system in early 1995 may go some way towards curtailing the ability of Thai banks to expand their balance sheets with foreign currency business, and limiting the resulting potential expansion in domestic demand.

But changes in US interest rates remain far more important for monetary conditions in Thailand. So far the BoT has welcomed increases in US interest rates, which has allowed Thai interest rates to rise to levels slightly less out of line with the high domestic rates of return on capital. And although further increases in US interest rates are likely, they are unlikely to seriously damage Thailand's good economic prospects.

However, although rising interest rates are good for macro-economic stability, they also raise the financing/opportunity cost of carry of positions in the Thai equity market for both foreign and local investors. Therefore as long as US rates are rising, the Thai equity market will be fragile; but if US rates peak in early 1995 while Thai economic growth and corporate earnings are still strong, the market could still be very attractive.

